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El efecto de los factores institucionales en el gobierno corporativo: implicaciones para la inversión transfronteriza

The effects of institutional factors on corporate governance : implications for cross-border investing

MEMORIA PARA OPTAR AL GRADO DE DOCTOR

PRESENTADA POR

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EL EFECTO DE LOS FACTORES INSTITUCIONALES EN EL GOBIERNO CORPORATIVO: IMPLICACIONES PARA LA INVERSIÓN TRANSFRONTERIZA

THE EFFECT OF INSTITUTIONAL FACTORS ON CORPORATE GOVERNANCE: IMPLICATIONS FOR CROSS-BORDER INVESTING

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Resumen

El efecto de los factores institucionales en el gobierno corporativo: implicaciones para la inversión transfronteriza

La protección del inversor está condicionada por la estructura de propiedad de la empresa y por el marco institucional del país en que esté basada. La atomización de la propiedad en las compañías cotizadas hace general el conflicto de interés entre directivos y accionistas, pero las empresas con un accionista de control se enfrentan a un segundo conflicto: los accionistas de control pueden abusar de su posición en detrimento del inversor minorista. En los países de derecho anglosajón, la dispersión de la propiedad raramente permite representación en el consejo a los inversores, pero el sistema legal facilita una notable protección al inversor. Por contra, los países con tradición civilista tienen un sistema de protección del inversor comparativamente más débil y las empresas frecuentemente tienen uno o varios accionistas relevantes que pueden controlar al equipo directivo de una manera efectiva (La-Porta et al., 1999).

En esta tesis identificamos mecanismos de gobierno corporativo relevantes para la atracción de capital extranjero, y prestamos especial atención al papel de los consejeros extranjeros para superar el sesgo doméstico de los inversores -*home bias effect*-. Comparamos la efectividad de la composición del consejo en distintos países para atraer inversores e incrementar el valor de la empresa, teniendo en cuenta el poder relativo de los principales accionistas de cada empresa. Por ultimo investigamos el impacto de la estructura de propiedad en la valoración empresarial, y su relación con el mecanismo de gobierno corporativo más extendido: la presencia de consejeros independientes.

Primero estudiamos las transacciones del mercado de capitales en las que el gobierno corporativo es especialmente relevante, dadas las asimetrías de información asociadas: aumentos de capital y salidas a bolsa. En estas transacciones, las empresas se enfrentan a un grado adicional de dificultad para atraer capital extranjero, dado el sesgo doméstico de los inversores -*home bias effect*-. Tanto las acentuadas asimetrías de información como el sesgo doméstico hacen a estas transacciones idóneas para analizar la efectividad del gobierno corporativo. Identificamos un reducido grupo de recomendaciones de gobierno corporativo que alientan la confianza de los inversores extranjeros para superar estos obstáculos y proveer financiación a empresas españolas que realizan aumentos de capital o salen a bolsa. De las 64 recomendaciones contenidas en el Código de Buen Gobierno para sociedades españolas, 10 recomendaciones relativas al consejo de administración, los estatutos y la junta general de accionistas; así como 6 relativas a los comités del consejo, son relevantes y positivas para atraer capital extranjero. Cuando un accionista de control está presente en la empresa, otras 7 recomendaciones son relevantes y positivas para atraer capital extranjero. También encontramos que una elevada proporción de consejeros extranjeros aporta un fuerte incentivo para que los inversores extranjeros participen en transacciones del mercado de capitales y que las empresas optan por un elevado porcentaje de consejeros extranjeros o por el cumplimiento de las recomendaciones relativas a los comités del consejo de manera alternativa.

En segundo lugar investigamos por qué, pese a la abundante literatura que estudia la contribución de los consejeros externos, menos sesgados y teóricamente mejor preparados para juzgar el desempeño de los directivos y proteger a los accionistas, los resultados sobre su contribución no son concluyentes. Hemos revisado los estudios de composición del consejo y desempeño empresarial con un doble enfoque. En primer lugar, hemos compensado la crítica habitual sobre la ausencia de consejeros genuinamente independientes y su designación por motivos de legitimización con una definición más exigente de independencia. Cuando tenemos en cuenta el marco institucional, encontramos significatividad estadística para la relación entre proporción de consejeros "fuertemente independientes" y la valoración de la compañía: esta relación es positiva en los países anglosajones. En segundo lugar, nos hemos sentido atraídos por la escasa atención dedicada a los consejeros externos que representan a un inversor. Los consejeros externos que representan a un inversor -consejeros "dominicales" en España- son especialmente adecuados para facilitar la provisión de recursos a la empresa -*resource provision*-, además de la tradicional función de control y supervisión -*monitoring*- de los consejeros externos. Los relevantes volúmenes de fondos precisos para lograr representación en el consejo son un incentivo para dedicar recursos, facilitar contactos y dedicar abundante tiempo al equipo directivo, dado el tamaño de la inversión que arriesga el inversor representado por el consejero dominical. Como las empresas habitualmente no tienen designados "consejeros dominicales" hemos analizado los currículums de 1977 consejeros en busca de vínculos con accionistas relevantes. De nuevo precisamos del contexto institucional para llegar a resultados significativos. Encontramos que en países de tradición civilista, en los que la concentración de la propiedad permite la representación en el consejo de accionistas significativos, el efecto positivo de los consejeros dominicales no compensa el efecto negativo de que varios consejeros dominicales correspondan a un único y poderoso accionista, que puede abusar de su posición en detrimento de los inversores minoristas. Sin embargo, la presencia conjunta de consejeros dominicales y una coalición de control que limite el poder del mayor accionista tiene un efecto positivo en la valoración de la empresa.

En tercer lugar, exploramos por qué, pese a la extendida presencia de accionistas relevantes o *blockholders,* que tienen los incentivos y los recursos para realizar una función de control y supervisión efectiva para influir en los directivos, oponerse a decisiones que no estén alineadas con los intereses de los accionistas y para favorecer decisiones encaminadas a la creación de valor, hay escasa evidencia empírica de su relación con el desempeño empresarial. Dado que la presencia de consejeros independientes es también un mecanismo de gobierno corporativo muy extendido para el control de los directivos y la protección de los inversores, hemos explorado la interacción entre ambos mecanismos, la presencia de *blockholders* y consejeros independientes, beneficiándonos de nuevo de nuestra definición reforzada de independencia. Encontramos una relación estadísticamente significativa y positiva entre una presencia conjunta de la proporción de consejeros independientes, el capital en manos de *blockholders* y la valoración de la empresa. Los consejeros independientes parecen actuar como un complemento a la presencia de *blockholders.* En segundo lugar, a medida que la participación accionarial del inversor se incrementa, tiene mayores incentivos para involucrarse y que la empresa incremente su valor Holderness (2003), por lo que el total de capital en manos de *blockholders* debería tener un impacto positivo en la valoración de la empresa. Pero la presencia de un *blockholder* que sea accionista de control influirá negativamente en la valoración. Encontramos que la presencia de un accionista de control es estadísticamente significativa, mitigada por el peso del resto de *blockholders.* Por último, encontramos significatividad estadística entre la valoración empresarial y la presencia de una coalición de control formada por el segundo y tercer accionistas con mayor participación, que pueden compensar el poder del mayor inversor. El efecto neto de los *blockholders* sobre la valoración dependerá del poder relativo de esta coalición: si el capital total en manos de *blockholders* es suficientemente alto, o bien el principal accionista o bien la coalición actuarán como accionistas de control, impactando negativamente en la valoración.

Summary

The effect of institutional factors on corporate governance:

implications for cross-border investing

Investor protection depends on the firm ownership structure and the institutional framework of the country where the firm is based. Diffusion of ownership in public firms extends to all companies the potential conflict between managers and shareholders, but firms with a controlling shareholder face a second conflict: controlling shareholders may abuse their position in detriment to minority investors. In common law countries, dispersed ownership seldom allows investors to be represented in the board, but the legal system provides remarkable investor protection. In contrast, Civil Law countries have a relatively weak legal system of investor protection and firms usually have one or several relevant shareholders that can effectively control management (La-Porta et al., 1999).

In this thesis we identify corporate governance mechanisms relevant to attract foreign investment, paying attention to the contribution of foreign directors to the overcoming of the home bias effect. We compare the effectiveness of board of director composition across countries to attract investors and increase firm value, considering the relative power of the main shareholders at each firm. Lastly we investigate the impact of ownership structure on firm value, and its relationship with the most widely used corporate governance mechanism: the presence of independent directors.

We firstly study capital market transactions where corporate governance is particularly relevant given the information asymmetries associated to them: capital increases and initial public offerings. In these transactions, firms face an additional degree of difficulty to attract foreign capital, due to the home bias effect. Both the enhanced information asymmetries and the home

bias effect make these transactions ideal to analyze the effectiveness of corporate governance. We identify a reduced set of corporate governance recommendations that foster foreign investors to overcome these obstacles and provide financing to Spanish firms conducting capital increases and IPOs. Out of the 64 recommendations contained in the Spanish Good Governance Code, 10 recommendations dealing with the board of directors, bylaws and general shareholder meeting; and 6 recommendations dealing with the committees of the board are found to be relevant and positive for attracting foreign capital. When a controlling shareholder is present at the firm, another 7 recommendations become relevant and positive to attract foreign capital. We also find that the presence of a high proportion of foreign directors is a strong incentive for foreign investors to participate in capital market transactions and firms use as alternative corporate governance mechanisms a high proportion of foreign directors and compliance with Committees recommendations

Secondly we investigate why, in spite of the abundant literature focusing on the contribution of outside directors, less biased and theoretically better prepared to judge manager's performance and protect shareholders, there are no conclusive results on their contribution. We have revisited the studies of board composition and firm performance with a two-fold approach. Firstly, we have compensated public criticism about the lack of genuinely outside-independent directors and their nomination to gain legitimacy with a more stringent definition of independence. When we account for the institutional framework, we find statistical significance for the relationship between the proportion of strongly independent directors and firm valuation: this relationship is found to be positive in common law countries. Secondly, we have been attracted by the scant attention devoted to outside-proprietary directors that represent investors. Outside directors that represent a significant investor or "proprietary directors" are particularly well suited for the resource provision role, in addition to the traditional monitoring role of outside directors. The significant amounts of funds necessary to get board representation are an incentive to commit resources, provide contacts and devote extensive time to assist the management team, given the size of the investment at risk made by the shareholder represented by the proprietary director. Since firms generally do not report "proprietary directors" we have examined the curricula of 1977 directors in search of ties with relevant shareholders. Again, we need the institutional context to arrive at a significant finding. We have found that in civil law countries, where ownership concentration allows relevant shareholders to have board representation, the positive effect of proprietary directors does not compensate for the negative effect of several proprietary directors representing a powerful largest shareholder, who may abuse his position in detriment to minority investors. But the joint presence of proprietary directors and a "controlling coalition" that limits the power of the largest shareholder has a positive impact on valuation.

Thirdly we explore why, in spite of the widespread presence of blockholders, who have the incentive and resources to perform effective monitoring and influence the firm's management, opposing managers' actions that not aligned with shareholders' interest and fostering decisions that lead to value creation, there is little empirical evidence about their relationship with firm performance. Since independent directors are also a widespread mechanism to judge manager's performance and protect shareholders, we have explored the interaction of both mechanisms; blockholders and independent director, benefiting again from our adjusted definition of independence. We find statistical significance for a joint and positive relationship between the proportion of strongly independent directors, blockholders capital and firm valuation. Independent directors seem to act as complement to the presence of blockholders. Secondly, as the ownership stake of the investor increases, he has a greater incentive to increase firm value Holderness (2003), so total capital accumulated by blockholders should have a positive impact on valuation. But if one of those blockholders is a controlling shareholder, he will negatively impact valuation. We find statistical significance of the presence of a controlling shareholder, mitigated by the volume of the remaining blocks. Lastly, we have found statistical significance of the positive effect on valuation of the presence of a controlling coalition between the second and third shareholders, who can compensate for the power of the largest investor. The net effect on valuation of blockholders will depend on the relative power of this coalition: if the sum of blockholders capital is high enough, either the largest shareholder or the coalition may become a controlling one, negatively impacting valuation.

Chapter 1. Introduction

Recurring accounting frauds and corporate failures, from Enron and WorldCom in 2001, to Madoff in 2008 and Toshiba in 2015, have contributed to the increasing relevance of corporate governance, attracting the attention of regulators, investors, corporations and scholars alike.

Corporations have thousands of shareholders and professional managers in charge of their operations. Not only these professional managers may have a conflict of interest with shareholders, conflict may also be found between controlling shareholders and minority investors. Corporate governance deals with mechanisms aimed at mitigating these conflicts and improving investor protection.

But investor protection also depends on the firm ownership structure and the institutional framework of the country where the firm is based. Diffusion of ownership in public firms extends to all companies the potential conflict between managers and shareholders, but firms with a controlling shareholder face a second conflict: controlling shareholders may abuse their position in detriment to minority investors. In common law countries, dispersed ownership seldom allows investors to be represented in the board, but the legal system provides remarkable investor protection In contrast, Civil Law countries have a relatively weak legal system of investor protection and firms usually have one or several relevant shareholders that can effectively control management (La-Porta et al., 1999).

In this thesis we will identify corporate governance mechanisms relevant to attract foreign investment, paying attention to the contribution of foreign directors to the overcoming of the home bias effect. We will compare the effectiveness of board of director composition across countries to attract investors and increase firm value, considering the relative power of the main shareholders at each firm. Lastly we will investigate the impact of ownership structure on firm value, and its relationship with the most widely used corporate governance mechanism: the presence of independent directors.

1. Two generations of corporate governance are not enough

Corporate governance research was initiated with a first generation of studies that analyzed the effectiveness of corporate governance mechanisms aimed at preventing corporate fraud and failure: first at the United States and later extended to other countries (Denis & McConnell, 2003)-. A second generation of studies has been developed to analyze the impact of legal systems and institutional frameworks on corporate governance in each country (Aggarwal, Erel, Stulz, & Williamson, 2009; Elshandidy & Neri, 2015; Iliev, Lins, Miller, & Roth, 2015). After these two generations of research, individual corporate governance mechanisms in a particular country have been analyzed, the contribution of the legal system to investor protection has been assessed (La-Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000b) and firm-level governance indexes across countries have been compared (Aggarwal et al., 2009). But there is a need to explore the link between individual mechanisms and the institutional framework in which these mechanisms are adopted. For argument sake: how can any conclusion be reached on the relationship between board independence and firm performance if no attention is paid to whether the country is characterized by dispersed ownership and the need to control managers or by a concentrated ownership structure, where controlling shareholders closely monitor executives?

Before stating our research question let us make some theoretical considerations on corporate governance first. In corporations, unlike small companies, (1) professional management is in charge of the company on behalf of shareholders and (2) ownership is unequal, with some shareholders owning a bigger proportion of a company than others do. Corporate governance arises in front of the conflicts poised either by management pursuing their own interest, rather than shareholders' interest; or by controlling shareholders extracting rents in detriment of minority shareholders. We will focus on publicly traded companies, since although all corporations are subjected to these potential conflicts of interest, publicly traded companies play a dominant role in corporate governance, due to the larger number of shareholders involved in them. Moreover, compared with private companies, publicly traded companies face an additional challenge: shareholders are able to easily transfer their shares to others should they believe that management or the controlling shareholder is behaving opportunistically.

Corporations are governed by their board of directors, no wonder that corporate governance study of board of directors is paramount. Members of the Board –"directors"- are formally appointed at the Shareholders Meeting, but there is significant controversy over to which extent the executives influence directors' appointments rather than shareholders' interests. Boards are in charge of designing the strategy of the firm and monitoring its execution by the top management team, but unfortunately the distinction between directors and executives is not clear. Sometimes the chairperson of the board is also the Chief Executive Officer (CEO), and occasionally the CEO and other executives are members of the board of directors, so controversy arises again over the motivation of the board to effectively control the top management team. Corporate governance deals with the size of the board, its composition – executives versus outsiders- and leadership structure –whether the chairperson is also the CEO.

Board of directors are also in charge with designing a compensation package for the top management team that aligns the interest of managers and shareholders. By establishing the structure of the executive compensation, the board of directors can incentivize the top management team to protect the interests of the shareholders.

There are other corporate governance topics that do not deal directly with available instruments to protect shareholders' interest but are certainly aspects indirectly influencing shareholders' protection, such as the ownership structure, the takeover market and the institutional framework. Ownership structure has a great importance on corporate governance: owners of significant percentage of capital –"blockholders"- may control managers and pursue overall shareholder value but there are also benefits available to blockholders, such as the possibility of extracting corporate resources, receiving private benefits of control that reduce the value of the firm to the other shareholders. This does not necessarily imply outright theft, it can be done through related party transactions not conducted at market prices, for example contracting consulting services from a company owned by one blockholder.

In spite of the control performed by the board of directors and the controlling shareholders, the executive team may be inadequate, unable or unwilling to manage the firm as to maximize its value. In these cases, the takeover market offers shareholders the possibility of selling their shares at a premium, transferring control of the firm to the bidder, who will in turn change the management team (Zhou & Guillén, 2018). Although the threat of a takeover may discipline managers, it may also work as a perverse incentive to "empire building", making the firm grow overpaying for acquisitions aimed at complicating the takeover (Unsal & Rayfield, 2019).

In countries where firms' ownership structures are widely held, individual shareholders own small fractions of the firms' shares, and shareholders have limited incentives to devote resources to monitoring the executives of the firm. In this environment it is essential that the institutional framework of the country guarantees that managers will not expropriate the funds invested by shareholders. In their seminal work "Law and Finance", La-Porta, Lopez-de-SIlanes, Shleifer, & Vishny (1998) analyzed how the legal systems affected investor protection, the origin of those legal-based rules, and the quality of their enforcement in 49 countries. The legal system is not only relevant for corporate governance: investor protection fosters financial markets development, facilitates external financing of new firms, reduces the concentration of concentrated ownership, improves the efficiency of investment allocation, an facilitates private restructuring of financial claims in a crisis (La-Porta et al., 2000b). La-Porta, Lopez-De-Silanes, Shleifer, & Vishny (1997) show that countries that protect shareholders have more valuable stock markets, larger numbers of listed securities per capita, and a higher rate of IPOs -initial public offerings-. Corporate governance also influences the real economy, since financial development can accelerate economic growth by enhancing savings and channeling these savings into the most productive investments.

Corporate governance research was initiated with a first generation of country-specific studies –starting in the 70s with the United States and extended to other countries in the 90s Denis & McConnell (2003)- that analyzed the effectiveness of corporate governance mechanisms aimed at preventing corporate fraud and failure. Examples of this first generation studies are the early work of Pfeffer (1972) on size and composition of board of directors in the United States, Wymeersch (1998) research on board of directors across Europe, Murphy (1999) in-depth study of CEO compensation in the US; Bryan, Nash, & Patel (2002) analysis of the use of equity in firm compensation structures in 43 different countries and Holderness (2003) research on the effects of insider and blockholder equity ownership on corporate decisions and on firm value.

Following the corporate scandals of the early 2000s, the United States passed the Public Company Accounting Reform and Investor Protection Act of 2002 called the "Sarbanes-Oxley Act", which implemented restrictive regulations such as increased responsibility for the CEO and Chief Financial Officer (CFO) -it was required to sign off the accuracy of quarterly financials and subject to criminal penalties if found negligent-, further disclosures –off balance sheet corporate information and potential conflict of interest of financial analysts covering the firm- and last, but very importantly, increased independence for the board of directors (Agrawal & Cooper, 2016). As mentioned earlier, corporate governance addresses in the first place the potential conflict between shareholders' interest and management pursuing their own. To mitigate this risk, the board of directors, appointed by the shareholders, decide on major strategic corporate decisions –versus the daily management of the company by the executive team- and requires independence from the firm and its executives. The "Sarbanes-Oxley Act" increased the relevance of non-executive directors, particularly at audit committees. Regulators around the world enforced similar rules and recommendations in each country. But did they take into account the specific characteristics of each country institutional and financial framework? Do corporate governance mechanisms travel efficiently?

A recent approach in corporate governance literature analyzes the impact of legal systems and institutional frameworks on corporate governance in each country (Aggarwal et al., 2009; Elshandidy & Neri, 2015; Iliev et al., 2015). Two corporate governance mechanisms have been mainly adopted worldwide after the regulatory wave initiated by the "Sarbanes-Oxley Act" in the United States to protect investors. Firstly, the requirement to incorporate independent directors to the board, being the notion of "independence" defined by the regulator. Secondly, special transparency requirements for those firms which choose to have the roles of CEO and Chairman of the board held by the same person were included. In an apparent contradiction, regulators have incorporated these mechanisms worldwide in spite of the fact that academic research is inconclusive on their impact on firm performance, specially under different institutional settings (Dalton, Daily, Ellstrand, & Johnson, 1998).

Extant research has analyzed individual corporate governance mechanisms in a particular country and compared legal systems La-Porta et al. (2000b) and firm-level governance indexes across countries (Aggarwal et al., 2009). Our study will intertwine the traditional corporate governance analysis –study of individual mechanisms- with the institutional framework, to address the following research question: what is the effectiveness of different corporate governance mechanisms in each institutional environment?

2. Scope and objective of this study

Considering the gap in the extant literature, this research will examine the relationship between corporate governance mechanisms and firm valuation by taking into account the institutional framework, so that we provide a better explanation of the circumstances under which a particular mechanism is more effective. Investor protection has been proved to be higher in countries where ownership structures are less concentrated, where capital markets are greater and where efficiency of resource allocation and economic growth is higher (La-Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000a).

Our study places a primary focus on corporate governance mechanisms that are at the reach of shareholders, since it is our goal to provide guidance on the choice of mechanisms to be implemented. Two mechanisms are clearly at the reach of shareholders: board composition and executive compensation. Since the theoretical and empirical literature on compensation is fairly well developed Murphy (1999), we will focus on board composition, a mechanism where the extant research is inconclusive. Dalton et al. (1998) provided evidence, through a meta-analysis of 85 studies of board composition and board leadership structure, that these board of directors' features, do not seem consistently linked to firm performance. Following the agency theory, we will study board composition as a corporate governance mechanism to monitor and control the management of the firm. We will distinguish between executive directors or "insiders" of the firm that belong to the top management team, and outside directors, either independent directors or *proprietary* directors representing a significant shareholder-. We will examine the relationship between board composition and firm valuation under the mediating influence of the institutional framework and ownership structure.

Although not totally at the reach of shareholders, we will also address the relationship between ownership structure, and more specifically the presence of significant shareholders, and firm value. Blockholders are shareholders with a relevant stake in the firm that allows them to gather more information on the firm than minority shareholders (Edmans & Manso, 2011). Investor relations departments may foster the acquisition of blocks -stakes over 5% of capital- by institutional investors. Monitoring managers is both time consuming and expensive and minority shareholders face a free rider problem to afford monitoring and prevent managers from behaving opportunistically. In the case of blockholders, the size of their stake makes it worthwhile to dedicate resources to monitoring and getting involved with corporate decision making, even more so when their stake allows them to be directly represented at the board of directors. Blockholders have the incentive and resources to perform effective monitoring and influence the firm's management, opposing managers actions that are not aligned with shareholders' interest -i.e. a dilutive acquisition- and fostering decisions that lead to value creation -i.e. substitution of underperforming CEOs-. Since blockholders will either intervene or sell their shares if managers underperform, their presence in the capital is a positive signal for other investors. After having examined the relationship between board composition and firm valuation, we will analyze whether the presence of blockholders is a complement to the most relevant corporate governance mechanism related to the board: the presence of independent directors.

This study contributes by developing a methodology to identify relevant corporate governance mechanisms in terms of cross-border investing, considering the effect on those mechanisms of an international board and the presence of a controlling shareholder. The adoption of these mechanisms incentivizes foreign investors to overcome the home bias effect and assume the host country's institutional framework.

The study also contributes to the literature on board composition by breaking up the outside director category and examining the impact of each kind of outside director under the mediating influence of the institutional framework of seven countries and the ownership structure of each firm. We provide a specific category of *strongly* independent directors that may influence firm valuation significantly, together with the identification of *proprietary* directors that, although representing significant shareholders, have attracted scant attention so far.

Lastly, the study will try to contribute to the literature on ownership structure by testing whether the presence of relevant shareholders is a complement to the most relevant corporate governance mechanism related to the board: the presence of independent directors. We take into account the role of controlling shareholders and the extent to which the power of the largest shareholder is contested to better understand the relationship between the presence of blockholders and firm performance.

1.3 Study structure

We start by reviewing the theoretical literature on chapter 2, discussing Agency Theory, Resource Dependence Theory, Stewardship Theory and Institutional Theory. Before analyzing the impact of different institutional frameworks we begin with the institutional framework of one country, Spain, to identify corporate governance mechanisms that have a significant impact in the decision of foreign investors to overcome the home bias effect and invest in a foreign country, assuming its particular institutional framework. In Chapter 3 we develop a methodology that assigns weights to 23 corporate governance recommendations in force since 2006 and identify those recommendations statistically significant for the decision by foreigners to invest in Spanish companies.

Chapter 4 analyses the relationship between board composition and firm valuation by examining two different kinds of outside directors: independent and *proprietary* directors. We analyze the impact of board composition on firm valuation under the moderating effect of different institutional frameworks -civil law versus common law countries- and different ownership structures.

After having examined the relationship between board composition and firm valuation, we will analyze in Chapter 5 whether the presence of blockholders is a complement to the most relevant corporate governance mechanism related to the board: the presence of independent directors. We investigate the relationship between blockholders and firm valuation in light of not only independent directos, but also of the presence of a controlling shareholder and the relative power of the three main shareholders. Conclusions are presented in Chapter 6.

Chapter 2. Theoretical background

2.1 Introduction

The literature offers different definitions for the term “corporate governance”, and it is useful to start with the most wide definition provided by Daily, Dalton, & Cannella (2003:371), according to which it is the “determination of the broad uses to which organizational resources will be deployed and the resolution of conflicts among the myriad participants in organizations”. In the same vein are Aoki (2000:11) “the structure of rights and responsibilities among the parties with a stake in the firm” and Aguilera & Jackson (2003:450), who define corporate governance as “relationships among stakeholders in the process of decision making and control over firm resources”.

Note that the above definitions use the terms “participants”, “parties” and “stakeholders”, since these definitions include different actors, such as shareholders, suppliers and employees. While shareholders make financial investments in the firm, suppliers and employees also make firm specific investments that are sunk costs, such as the design of a product or the learning process of a firm software. Under a stakeholder approach, corporate governance is “set to prevent that groups with more bargaining power extract rents from groups with less bargaining power in the case of an incomplete contract” (Arranz, 2015):96). Countries where employee protection is relevant adopt a stakeholder approach to corporate governance, such as Japan, Germany, Austria and Denmark, with two tier or dual boards, in which employee participate through the supervisory board.

The main objective of corporate governance studies is to protect the shareholder, so the main actor is the shareholder, who is risk bearer and residual claimant, and ownership rights and the need to mitigate the agency problem -aligning managers and owners' interests- will be at at the center of corporate governance. Focusing on the owners of the firm, many definitions have been stated, such as Core, Guay, & Larcker (2003):27 "set of complementary mechanisms that help align the actions and choices of managers with the interests of shareholders", Denis & McConnell (2003) "set of mechanisms-both institutional and market-based-that induce the self-interested controllers of a company -those that make decisions regarding how the company will be operated- to make decisions that maximize the value of the company to its owners -the suppliers of capital-", La-Porta et al. (2000b) "a set of mechanisms through which outside investors protect themselves against expropriation by the insiders" or Shleifer & Vishny (1997) definition based on "ways in which suppliers of finance to corporations assure themselves of getting a return on their investment".

The objective of this research is to explain how corporate governance mechanisms contribute to shareholder protection and therefore to the increase of their wealth in the firm's equity. Therefore, and taking into account the previous definitions, we adopt the following one: "*Corporate governance is the set of mechanisms that are at reach of shareholders and can be used to protect their wealth*".

This definition firstly implies that protection of minority shareholders will be at the core of the analysis, but considering threats from both managers and controlling shareholders. Rent extraction from shareholders' wealth may be caused by a block shareholder if the conflict is between minority and controlling shareholders. In countries where ownership structure of firms is atomized the prevalent corporate governance potential conflict will take place between shareholders and managers, while in those countries where the capital structure is more concentrated, the prevalent conflict will take place between minority and controlling shareholders. In any case, corporate governance deals with the protection of shareholders.

Secondly, the expression “at reach of shareholders” is used to point out that the analysis will be focused on the choice of mechanisms over which shareholders can decide –i.e. to select a high proportion of independent directors- versus others over which shareholders have no power –i.e. the legal system-. In this study we are concerned with mechanisms at reach of shareholders, and we will explore how other factors outside their reach moderate the influence of the main mechanisms on investor protection.

This study places shareholder at the center of the analysis. Shareholders directly participate in the firm decision making at the annual or extraordinary meetings, delegating the strategic decisions to the board of directors, which in turn delegate the daily operations of the firm to the CEO and the rest of the management team. Corporate governance deals with the functioning of both shareholder meetings and the board of directors. Board of directors meet frequently and adopt very important decisions, with the shareholder meeting ratifying–or vetoing- the proposals of the board of directors. Our study will focus on both the ownership structure of the firm and the functioning of the board of directors, an essential institution in which shareholders delegate strategic decision making. As mentioned before, the board of directors is comprised of (1) executive directors or “insiders” of the firm that belong to the top management team, and (2) outside directors, either independent directors or “proprietary directors” representing a block-holder or relevant shareholder.

We will review now four theoretical streams of management theory –agency, resource dependence, stewardship and institutional theory- that advocate for different roles for the members of the board of directors.

2.1 Agency theory

Under the agency theory, the firm is described as a set of contracts among factor of productions –labor, capital- and customers. These contracts will involve property rights Demsetz (1967), whose definition will be determinant for the way in which costs and rewards are allocated to the participants in the firm.

Jensen & Meckling (1976) define an agency relationship as a contract under which one or more persons –"principals"- engage another person –"agent"- to perform some service on their behalf which involves delegating some decision making authority to the agent and described three kinds of agency costs: those derived from the design of contracts and monitoring expenditures by the principal; bonding expenditures by the agent and residual costs, since in spite of monitoring and bonding expenditures, it is not possible to perfectly match the principal's interest and the agent's actions. Residual costs are the value of the reduction in principal's welfare due to this mismatch.

To understand the implications of the agency relationship on corporate governance, it is useful to identify who is responsible for each step of the decision making process at the firm. Fama & Jensen (1983b) characterize the decision process at the firm in four steps: initiation -proposals for resource utilization and contracts design-, ratification -choice of initiative to be implemented-, implementation of the ratified decisions and monitoring -performance evaluation and implementation of rewards-. These authors characterized "decision management" as comprising the initiation and implementation steps, usually undertaken by the same person: the agents or managers of the firm; while the decision control function comprises the ratification and monitoring steps, undertaken by the principal, or the people designated (i.e.

the Board of Directors). Assuming both the agency problem and the tendency of managers not to maximize the wealth of shareholders, it is essential to keep daily decision-making –"decision management"- apart from the control of such decision-making -decision control. Fama & Jensen (1983b) explained the survival of firms where ownership and control were apart: in these companies the agents do not bear a substantial share of the wealth effects of their decisions and it is particularly important that mechanisms are put in place to prevent agents from damaging the principals' wealth.

Imperfect information to monitor managers makes difficult enforcing limits to management discretion. Also, if shareholders own a diversified portfolio, they will not have the incentive to invest considerable resources to the monitoring of the stakes in each company, facing the free rider problem, and suffering a tendency to sell rather than to struggle for control (Eisenhardt, 1989).

Shareholders, providers of capital -"principals"-, need the expertise of managers to produce a returns on their funds and managers –"agents"- need providers of funds since they can not finance the project by themselves. Jensen & Meckling (1976) warned about the residual costs, the reduction in principal's welfare due to the mismatch between the principal interest and the agent's actions. The agency problem arises in front of the uncertainty that shareholders face: will their funds be expropriated or wasted by managers? Shareholders will maximize dividends and stock prices while managers will prefer growth: empire building will bring them higher salaries and prestige. Both parties will need to engage in a contract that regulates how the funds are used and how profits are shared. Since not all possible circumstances can be foreseen, "residual rights of control" will have to be allocated (Shleifer & Vishny, 1997):744. Although the principal will set limits to the agents' discretion to allocate funds in unforeseen circumstances, managers will end up with significant discretion for self-interested behavior, since principals will often lack information or expertise to decide in unexpected situations, the very reason why agents are hired (Shleifer & Vishny, 1997).

In practice, the agents -managers- may divert corporate assets by selling assets to themselves – or to companies controlled by them- at favorable prices, by above market salaries or stock options or through outright theft. The conflict of interest may not imply diverting corporate assets, but simply using them to pursue investment strategies that yield them personal benefits of control, such as growth or diversification -"empire building"- at the expense of the principal's interest -risk-bearing shareholder- (La-Porta et al., 2000a).

So if the agents can behave opportunistically, what can be done to ensure that they would act in the best interest of the principal? From the perspective of the principal, shareholders may set up adequate incentives for the agent and monitor agent's behavior and the agent. And the agents may also be required to spend resources to guarantee that the principal will be compensated should his interest be harmed by the agent. These mechanisms will be the essence of corporate governance: since conflicts of interest arise from the separation of ownership and control, and there are unavoidable costs to mitigate the agency problem that end up reducing the value of the firm, "how do entrepreneurs, shareholders, and managers minimize the loss of value that results from the separation of ownership and control?" (Denis & McConnell, 2003). The answer to this question comes close to the definition of corporate governance. Corporate governance mechanisms provide shareholders some assurance that managers will work towards outcomes that are in the shareholders' interests (Shleifer & Vishny, 1997).

Since the control of managers is assigned to the Board of Directors, which acts on behalf of shareholders, directors have an agency role, that is, "a governance function in which they serve shareholders by ratifying the decision of managers and monitoring the implementation of those decisions". When managers are not efficient, directors will replace them to improve performance. So non-executive directors will be less biased and better prepared to judge manager's performance and protect shareholders (Hillman, Cannella, & Paetzold, 2000). Directors also play a fundamental role in mitigating the agency problem by requiring the firm to increase its level of transparency, therefore reduce information asymmetry and agency costs. Accurate financial and risk information reduces agency costs and is therefore key for shareholders, enabling them to assess a company's risk profile, estimate its value and make accurate investment decisions. In this vein risk information is reallocated between insiders -management- and outsiders -shareholders-, being voluntary disclosure -"transparency"- a corporate governance mechanism to address agency problems (Elshandidy & Neri, 2015).

The control of managers proposed by the agency theory is consistent with limiting CEO power or "residual rights of control" (Shleifer & Vishny, 1997). Corporate governance literature has also explored the power relationship between CEOs and boards of directors (Daily & Johnson, 1997; Finkelstein & D'Aveni, 1994; Kieschnick & Moussawi, 2018; Miyajima, Ogawa, & Saito, 2018; Mizruchi, 1983) and CEO succession processes (Cannella & Shen, 2001; Monks & Minow, 1991; Shen & Cannella, 2002; Wade, Reilly, & Chandratat, 1990).

Regarding CEOs and board of directors, Mizruchi (1983) proposes that the board of director has a supervising role over management, not the other way round. That is, it is necessary to differentiate the roles of each one according to the the strategic/operational dimension of decisions: while managers are in charge of day-to-day operations, directors focus in the long-run policy monitoring, that varies with performance of the firm, and includes hiring and firing the CEO. Daily & Johnson (1997) have found a lagged and reciprocal relationship between CEO power and firm performance. It also seems that CEOs need a track record of financial success in the running of their company before they gain the necessary prestige to be invited to other boards, but once they join other boards, they establish professional relationships that enhance their own firms' financial performance, in a sort of virtuous circle. A higher level of firm performance lead to lower proportion of independent directors in the following year and even that lower proportions of independent directors correlate negatively with firm performance in the following years. These findings seem contradictory with the idea that independent directors are necessary to control managers' power and protect shareholders, but it is well worth mentioning that the lack of a homogenous definition of "independent director" may be the reason for the apparent contradiction. For a start, if the independent director is appointed during the CEO mandate, she might have been chosen because of her relationship with the CEO in the first place, limiting her ability to independently protect shareholder's interests. Wade et al.(1990) differentiated between independent and interdependent directors: while the formers are outside directors appointed prior to the current CEO's appointment, interdependent directors are inside directors or outside directors appointed by the current CEO.

Compensation is useful to measure CEO power within the firm. Daily & Johnson (1997) provide evidence that increases in CEO compensation, relative to the executives, are often found regardless of firm performance in the previous years. Rather than increasing compensation as a reward for past performance, compensation is raised ex-ante trusting the CEO to foster performance later on, which increases her power. Educational prestige of CEOs also plays a relevant role in their power stance. An elite educational background lead to significant discretion been granted to the CEO, who may abuse this extra power and harm shareholder value. Wade et al. (1990) studied whether the granting of golden parachutes to CEOs is the result of economically rational process or determined by social influence of CEO. The show that CEOs who serve on many outside boards, and therefore are likely to have a better social reputation and be more familiar with golden parachutes, are more likely to have a golden parachute, and also that CEOs with a higher tenure relative to the board are more likely to receive this kind of contingent compensation.

Regarding the CEO succession process, and the role of CEO power on it, Cannella & Shen (2001) studied the factors influencing the outcomes associated with their apparent tenure -

promotion to CEO or exit from the firm- and found a negative association between CEO power and promotion of the heir apparent, and also that CEO power increases the likelihood of exit for the heir apparent when firm performance is above average. Also, Shen & Cannella (2002) conducts a times series analysis of the antecedents of CEO dismissal followed by inside succession, finding that higher risk of dismissal for outsider CEOs is a result of them lacking social networks and power bases within their new firm. They also provide evidence that CEOs are in weak positions and are at high risk of power contests in the early years of their tenure.

Aguilera & Jackson (2003) point out several limitations of using Agency Theory to explain corporate governance, in the absence of the institutional framework, such as the existence of different stakeholders within the principal-agent relationship –i.e. banks, institutional investors, families that pursue different interests- or the several interdependencies among stakeholders that are ignored –i.e. employee role in board of directors, interfirm ownership-.

Another limitation of the Agency Theory is that it does not explore other roles for the member of the board of directors different from monitoring and does not benefit form the contributions of psychology and sociology to achieve a more complete understanding of managers' motivations.

In summary the agency theory has played a seminal role in the development of corporate governance literature. As a mainly economic perspective, it focuses on the monitoring role of directors, assuming the need to control managers given the misalignment between shareholders and managers. Corporate governance mechanisms that minimize agency costs will be appropriate under this perspective –i.e. independent boards with a majority of outside directors or the CEO position not occupied by the chair of the board, as is the case of "executive chairmen" or "dual CEOs"- (Krause, Semadeni, & Cannella, 2014). Agency theory is, in our view, the most powerful theory to approach corporate governance analysis.

Tables 1 and 2 summarize the main review and empirical studies that deal with corporate governance issues from an agency theory perspective.

Table 1. Corporate governance and agency theory literature: review papers

Authors	Issue	Main conclusions
Eisenhardt (1989)	What are the contributions of agency theory, both positivist and principal-agent research?	• Positivist researchers: situations in which principal and agent have conflicting goals at large, public corporations Governance mechanisms: outcome-based contracts effective in curbing agent opportunism and information system curb agent opportunism • Principal-agent research: general theory, set of assumptions and mathematical proof. Theory applied to employer-employee, lawyer-client, buyer-supplier, etc. Focus: determining the optimal contract, behavior versus outcome. Key variables: information systems, outcome uncertainty, risk aversion, goal conflict, task programmability, outcome measurability, length of agency relationship
Shleifer & Vishny (1997)	International corporate governance review paper with special attention to legal protection of investors and ownership concentration	• Concentrated ownership: good to control management but potential exploitation of minorities: importance of legal protection • Japan/Germany: permanent large shareholders and banks discourage small investors • USA: because of bankruptcy protection, creditors have relatively fewer rights than do creditors in Germany and Japan • Japan falls between the United States and Germany in the degree of protection of both shareholder and creditor rights • Rest of the world: legal protection of investors is lower, firms remain family-controlled and have difficulty raising outside funds
La-Porta et al. (2000b)	Is there a common explanation for differences among corporate governance in countries?	• Even among countries with well functioning judiciaries, those with laws and regulations more protective of investors have better developed capital markets • Common law countries have the strongest protection of outside investors (shareholders and creditors), German civil law and Scandinavian countries intermidate and French civil law countries the weakest • The vague fiduciary duty principles of the common law are more protective of investors than the bright line rules of the civil law • Civil law is associated with greater government intervention in economic activity and weaker protection of private property than common law • When investor rights are poorly protected and expropriation is feasible on a substantial scale, control acquires enormous value because it gives the insiders the opportunity to expropriate efficiently
Bushman & Smith (2001)	Role of publicly reported financial accounting information in corporate governance	• Use of externally reported financial accounting in control mechanisms that promote corporate governance • Important role of financial accounting in managerial incentive contracts, but also relevant for takeovers, proxy contests, shareholder litigations, debt contracts and audit function • Governance use of financial accounting affects allocation of resources in an economy: discipline mangers to direct resources towards good projects and reduces information asymmetries

Table 1. Corporate governance and agency theory literature: review papers (continued)

Authors	Issue	Main conclusions
Daily et al. (2003)	Corporate governance literature summary	• Theories: agency, resource dependence, stewardship and power theories • Practice: shareholder activism (outside directors, non duality, age and term limits for directors, contingent forms of pay for executives) • Scant evidence that control over executives and independence of oversight have been productive from a shareholder-oriented perspective • Challenge for directors is to build and maintain trust in their relationships with executives, but also to maintain some distance so that effective monitoring can be achieved • Board independence is related to firm performance, as measured by the incidence of bankruptcy filing
Denis & McConnell (2003)	Survey of two generations of corporate governance around the world	• Significant differences across countries in the degree of investor protection: countries with low investor protection have higher concentration of equity ownership and a lack of significant public equity market • Laws in common law countries provide the strongest degree of protection for shareholders, while the laws in French civil law countries provide the least protection. Enforcement of the laws is stronger in the German and Scandinavian law countries than in the common law countries, with the weakest enforcement observed in French civil law countries • Two ways to extract value through private benefits of control: tunneling- transfer of assets/profits from company to controlling shareholder as in pyramid ownership structures- and choosing managers
Young Peng, Ahlstrom, Bruton, & Jiang (2008)	Corporate governance in emerging economies	• Corporate governance in emerging countries, rather than principal-agent conflict, is a controlling versus minority shareholder conflict • Informal institutions (relational ties, business groups, family connections, and government contacts) have greater role in shaping corporate governance • Firms may rely more heavily on dominant ownership for corporate governance reasons. External control mechanisms (product, labor and takeover markets) are corrupted or ineffective and thus less effective in governing top managers than internal control mechanisms

Table 2. Corporate governance empirical papers based on agency theory

Authors/Sample	Research question	Dependent variable	Independent variables	Research findings
(Wade et al., 1990) Sample of 89 firms, representing nine industries, from Business Week's (May 6, 1985) annual survey of executive compensation for 1984	Whether the granting of golden parachutes to CEOs is the result of economically-rational process or determined by social influence of CEO	Golden parachute	• Firm size • Concentration of ownership • Board size • % outside directors appointed after CEO • Board tenure of CEO • CEO relative board tenure • Number of boards CEO serves on Firms market-to-book ratio	• Both economic and social influence perspectives have merit and the importance of each may depend on the ownership structure of the firm • Larger firms less likely to become takeover targets; hence, there is less need to use golden parachutes to align shareholder and management interest. • Negative association between golden parachutes and takeover risk as indexed by EXCESS (firm's total market value minus book value of its assets) • CEOs who serve on many outside boards, and therefore are likely to have a better social reputation and be more familiar with golden parachutes, are more likely to have a golden parachute • CEOs with a higher tenure relative to the board are more likely to receive a golden parachute
Daily & Dalton (1994) 57 bankrupt firms and 57 surviving firms, 1972-1982, Dun and Bradstreet, Securities and Exchange Commission	What is the relationship between governance structure and corporate bankruptcy?	Corporate bankruptcy	• Proportion of affiliated directors (insiders or blockholders) • CEO duality	• There is a positive relationship between governance structure and bankruptcy • Bankrupt firms have a greater incidence of joint CEO-board chairperson structure than survivor firms • Bankrupt firms will have higher proportions of affiliated directors than survivor firms • The interaction between CEO-board chairperson structure and the proportion of affiliated directors will distinguish bankrupt from survivor firms

Table 2. Corporate governance empirical papers based on agency theory (continued)

Authors/Sample	Research question	Dependent variable	Independent variables	Research findings
Finkelstein & D'Aveni (1994) All public firms in printing and publishing, chemicals, or computers according to Ward's Directory (1984- 1986)	What is the relationship between board of directors and CEO duality	CEO duality	Board vigilance • Proportion of outside directors • Proportion of firm shares owned by outside board members Moderator variables: • Informal CEO power • Firm performance	• The association between board vigilance and CEO duality changes with circumstances. When CEOs have strong informal power or when firm performance is good, the risk of CEO entrenchment increases, making duality less desirable. • When other influences are held constant, it appears that vigilant boards are more concerned with unity of command than with entrenchment avoidance
Daily & Johnson (1997) 100 randomly selected Fortune 500 firms, 1987-1990	What is the nature of the relationship between CEOs' power and firm financial performance?	Firm financial performance	• Structural power • Ownership power • Prestige power • Expert power	• Lagged and reciprocal nature of the relationship between CEO power and firm performance • Higher levels of performance lead to greater number of corporate directorships for the CEO in the subsequent year • CEO's service on other corporate boards enhances their own firm's financial performance • Higher levels of firm performance lead to lower proportions of independent directors in the following year • Higher levels of relative compensation led to higher firm performance in subsequent years • Educational prestige was associated with lower market returns

Table 2. Corporate governance empirical papers based on agency theory (continued)

Authors/Sample	Research question	Dependent variable	Independent variables	Research findings
Cannella & Shen (2001) Data from 168 large U.S. manufactures, publicly traded, COMPUSTAT, 1986-1991	What are the factors that affect the alternate outcomes associated with heir apparent tenure - promotion to CEO or exit from the firm-?	Status of the heir apparent: promote of to CEO, exit from firm or no change	• Heir apparent power • Incumbent CEO power • Outside director power • Firm performance	• Negative association between CEO power and promotion • CEO power increases likelihood of exit when performance is above average • Outside director power decreased the likelihood of exit when performance is high but increase it when it is low • An heir apparent with longer company tenure is less likely to exit
Shen & Cannella (2002) Random sample of 387 firms reporting at least $200 million sales. Data for 1988-1997: annual reports, Dun&Bradsteet and Dow Jones	What factors drive CEO dismissal when followed by inside succession?	CEO dismissal followed by inside succession	• CEO origin • CEO tenure • Proportion of non-CEO inside directors • Non-CEO executive ownership	• Both proportion of non-CEO inside directors and Non-CEO executive ownership positively impact CEO dismissal followed by inside succession • Senior executives are potential power contenders and relevant for CEO dismissal followed by inside succession • Higher risk of dismissal for outsider CEOs is a result of their lacking social net-works and power bases within their new firm • CEOs are in weak positions and are at high risk of power contests in the early years of their tenure
Elshandidy & Neri (2015) 1,890 annual reports (from 290 British non-financial firms and 88 Italian non-financial firms)	Measure influence of risk disclosure practices in the UK and Italy on corporate governance and market liquidity	Risk disclosure	Corporate governance measures • board size • non executive directors • independent non executive directors • CEO duality • Dividend yield • Concentrated ownership • Audit quality	• Governance (incentives) factors influence UK firms' decision to reveal or conceal voluntary (mandatory) risk information. Contrary to those findings, incentive (governance) factors influence Italian firms' decision to reveal voluntary (mandatory) information in the narrative sections of their annual reports.

2.2 Resource dependence theory

Besides the governance function of the board of directors –controlling managers and ensuring that corporate action is aligned with shareholders' interests-, the board has an institutional role: they serve as a link with the external environment, contributing to resource acquisition.

Members of the board of directors allocate their attention to various functions such as resource provision, environmental scanning, opportunity seeking, and management monitoring (Tuggle, Sirmon, Reutzel, & Bierman, 2010). In the Resource Dependence Theory, several factors are a source of uncertainty and external dependencies that directors can help to mitigate –ie: availability of capital, regulatory environment, new technologies, etc.- (Pfeffer & Salancik, 1978). Firms are owned by shareholders who invest capital to get a return on it, and that means assuming risks and uncertainty about resource acquisition and the subsequent profitability of investments. Directors help the firm coping with shareholders' uncertainty by contributing their industry and functional expertise, networking, legitimacy, access to suppliers, buyers, public policy decision makers and social groups, therefore increasing survival likelihood (Gales & Kesner, 1994; Singh, House, & Tucker, 1986).

Directors have been classified into two broad categories from a legal point of view, as executives versus external, being the later either independent or block holder directors representing a relevant shareholder. From the point of view of the resource dependence theory, Hillman et al. (2000) propose four kind of directors, according to the main role assigned to each:

1) **Insiders:** directors who are or were managers or owners of the firm. The reason for appointing someone as an "insider" director is the privileged view that she has on both the firm and the sector in which it operates.

2) **Business experts**: directors appointed on the basis of their expertise in other firms or organization, which is valuable for operations design, providing an alternative point of view –how other firms deal with similar issues- to that of the executives of the company. Business experts may also contribute to the firm strategy design drawing from their knowledge of the sector and comparable companies, and this is a key element to ensure the competitive position of the firm

3) **Support specialists:** directors with a specialized expertise useful for the senior management, for example in the areas of capital markets, law or insurance. They are different from business experts since they do not have general management experience, they may have an academic or institutional background.

4) **Community influentials:** directors with experience relevant to the firm's environment beyond competitor firms and suppliers. These directors have knowledge or influence on non-business organizations, such as the government, the parliament, the university and various social organizations, and this knowledge is valuable since these groups impact or are impacted by the firm operations. Their expertise might prevent the firm from inadvertently taking decisions negatively affecting other interest groups, such as environmental groups, trade unions, etc.

While agency theory prescribed independent boards dominated by external directors, the resource dependence theory advocates for boards with a balanced representation of different kind of directors, who provide resources and information to the firm, thereby reducing environmental dependency and improving the effectiveness of strategic choices inside the firm. Moreover, the access to valuable resources increases legitimacy by enhancing the reputation and credibility of their firms. The extent to which directors benefit the firm depends on whether their inclusion provides access to valued resources and information, reduces environmental dependency, or aids in establishing legitimacy (Daily & Dalton, 1994; Daily & Schwenk, 1996; Hambrick & D'Aveni, 1992).

According to Pfeffer & Salancik (1978:167), boards are "vehicles for co-opting important external organizations" –ie: a banking executive is appointed as member of the board in order to have a good relationship with banks - and they can benefit the firm in the following ways: (1) provision of specific resources, such as expertise and advice from individuals with experience in a variety of strategic areas; (2) channels for communicating information between external organizations and the firm; (3) aids in obtaining commitments or support from important elements outside the firm; and (4) legitimacy. Pfeffer (1972) considers the board of directors a "vehicle for dealing with problems of external interdependence and uncertainty, resulting from its exchange of resources with important external organizations", and that board size and composition are shown to be "systematically related to factors measuring the organization's requirements for coopting sectors of the environment". When firms fail to use boards to manage their environments, they pay a penalty in terms of lower performance (Pillai & Al-Malkawi, 2018). This cooptation is an alternative to absorbing external organizations and dealing with interdependence through mergers or long-term contracts. Cooptation uses the board of directors by incorporating to it representatives of important external organizations with which the firm has interdependences. Cooptation will be particularly useful with large organizations that are difficult to absorb, as well as other organizations where absorptions is not feasible, such as financial institutions and political bodies.

Boards increase their size and the diversity of its members as a response to resource dependencies. Also larger boards might improve corporate governance by increasing the difficulty for the CEO to dominate the board of directors. In the same vein, Dalton, Daily, Johnson, & Ellstrand (1999) meta-analyzed 27 studies that dealt with the relationship between board size and firm performance, finding a non-zero, positive relationship, particularly in the case of smaller firms, consistent with the idea that a higher number of directors allow the company to benefit from the local expertise of executive directors and linkages of outside directors.

The resource dependence theory emphasizes the need of the firm for environmental linkage, which will vary according to the kinds of dependence that the firm faces (Dinh & Calabrò, 2019). Whatever the dependences, the firm will have to afford transaction costs to gather the needed resources. In the case of a firm operating in a regulated sector, having outside directors with a public sector background will surely reduce transaction costs by gaining knowledge of the procedures to comply with the regulations, the right contacts to whom each issue must be addressed and even to gain influence on the drafting of the regulations that affect the firm. So besides facilitating the firm access to resources, directors also reduce transaction costs thanks to their networking with the institutions with which the firm interacts (Williamson, 1984). Director interlocks also have an important role in information dissemination across firms (Lynall, Golden, & Hillman, 2003).

Empirical research Meyer (1982); Smith & Grimm (1987) has proved that changes in the environment of the firm, such as shifts in regulatory or technological environment, cause strategic changes in the firm. But changes will not be limited to the inside of the corporation: the new environment will require new linkages which imply a re-configuration for the board of directors, since its members are the main link with the external environment. Corporate boards reflect the firm's environment and directors should be chosen considering their capacity to contribute to the provision of strategic resources to the firm. In this vein the board of director will be able to contribute to the strategic change and reduce the uncertainty faced by firm under the new environment (Albuquerque, Brandão-Marques, Ferreira, & Matos, 2018; Hillman et al., 2000).

In summary, the resource dependence model offers a much more eclectic view for the role of a member of the board of directors. While under agency theory, this role was mainly monitoring, resource dependence identifies several roles, and does not focus on controlling managers. All directors are valuable as long as they contribute to obtain resources and reduce environmental uncertainties. Executive directors' main role is not to control managers, but to provide their privileged view on both the firm and the sector in which it operates. The board of directors, rather than an instrument of control, is an instrument of contribution to the firms' operations. A board composition with a majority of external board directors will be appropriate –to provide the environmental linkages advocated by this theory-, but no preference for a particular leadership structure –CEO duality- is clearly derived from the theory. The resource dependence model contributes to the analysis of board of directors by identifying enriching roles for outside directors but does not address the main problem of corporate governance: the protection of the minority shareholder. Tables 3 and 4 summarize the main conclusions of several theoretical, review and empirical papers that deal with corporate governance from a resource dependence theory perspective

Table 3. Corporate governance and resource dependence theory literature

Authors	Topic	Main conclusions
Williamson (1984) (theoretical paper)	General essay on corporate governance	• Corporate governance involves all constituencies (labor, owners, suppliers, customers, the community, and management) but representation on the board of directors should be strictly limited • Boards reduce transaction costs associated with environmental interdependency • The board of directors should be regarded principally as a governance instrument of the shareholders
Daily & Schwenk (1996)	Under which conditions alternative "governance structures" (top management teams-CEOs-board of directors) develop	• CEO dominance and board dominance models will be associated with greater performance than alternative governance models • Efficacy of dominant or balanced structure depends on "attendant conditions": ownership concentration, portfolio exposure and resource dependence and information requirements • Homogenous top management teams are superior under conditions of modest portfolios, low globalization and low information requirements
Dalton et al. (1999) (meta-analysis)	Relationship between board size and firm performance	• Non-zero, positive relationship. Particularly for smaller firms. • Larger boards can leverage all roles of directors: inside directors (offering local expertise, training and succession), affiliated directors (resource dependence links) and other outside directors (independence, monitoring role)

Table 4. Corporate governance empirical papers based on resource dependence theory

Authors and sample	Research question	Dependent variable	Independent variables	Research findings
Singh et al. (1986) 389 voluntary social service organizations in Toronto, Canada, during 1970-1980.	What is the impact of organizational change in their survival?	Organization death rate	• CEO change • Service area change • Goal change • Location change • Structural change	• Organizational change processes more relevant in population change for institutional organizations than for technical organizations • Impact of organizational changes depends on stage of organizational life cycle at the time of change • Core organizational changes best described by an ecological view and more disruptive, whereas peripheral organizational changes best described by an adaptation view and lowered death hazard
Smith & Grimm (1987) 27 railroad companies' strategies before and after deregulation (54 observations)	What are the effects of deregulation on strategic management in the railroad industry?	Return on investment / capitalization / equity	Strategy move: • Unfocussed follower to contingency • Contingency to leadership • Unfocused follower to innovation • Quality differentiation to contingency • Contingency to unfocused follower	• Most firms changed their strategies in response to environmental variation, and those that did change their strategies outperformed those that did not • Among the strategic changes, those involving innovation and contingency strategies were found to be the most profitable
Hambrick & D'Aveni (1992) 57 firms filing either Chapter X or XI bankruptcy petitions during 1972-1982. For each bankrupt, a matched survivor.	What is the relationship between top management team of large corporations and bankruptcy?	Bankruptcy	• Team size • Outside board members • Functional expertise • Team compensation • Tenure in the firm • Tenure heterogeneity • CEO dominance	• Failing firms tend to show significant divergence - relative to survivors- in the composition of their top management teams, specially over the last five years of the bankrupts' lives • Team deterioration aggravates corporate decline, either through strategic errors or stakeholders' dissatisfaction with the visibly diminished team • Corporate decline brings about team deterioration, through a combination of voluntary departures, scapegoating, and limited resources for attracting executive talent

Table 4. Corporate governance empirical papers based on resource dependence theory (continued)

Authors and sample	**Research question**	**Dependent variable**	**Independent variables**	**Research findings**
Gales & Kesner (1994) Sample of 279 bankrupt firms form Funk and Scott's Index of Corporate Change 1978-1985 and non-bankrupt firms from Ward's Directory	What is the impact of boards in bankruptcy?	Firm's survival	• Size of board of directors • Proportion of outside directors	• Boards that eventually filed for bankruptcy are smaller and have fewer outsiders than non bankrupt counterparts, in line with the resource dependence theory • After bankruptcy, boards have fewer outside directors, since the bankruptcy court takes on the monitoring role of outsiders, in line with the agency theory
Hillman et al. (2000) 557 directors from 14 airlines during 1968-1988, annual reports, proxy statements, 10K reports, Standard & Poors Register of Corporations.	What is the relationship between board composition and changes in the firm's environment?	Board replacements	Regulated versus unregulated environment	• As environments change, the composition of boards will change to reflect the shift in resource needs confronting the firm • From a regulated to a deregulated environment, firms tend to strategically alter the composition of their boards • During regulation board replacements were more likely from the insider and support specialist category, while during deregulation board replacements were more likely to come from the business expert and community influential categories

2.3 Stewardship theory

The stewardship theory undertakes an organizational psychology and sociological perspective, having the concept of authority at its core. As a complement to the agency theory, that focuses on the need to control managers, the stewardship theory considers that managers are also motivated by non-financial factors (Donaldson & Davis, 1991). Stewardship theory considers that the model of human motivation underpinning agency theory is narrow, characterizes managers in a unnecessarily negative way and suffers from an individualist bias, in detriment to the role played by team coordination (Donaldson, 1990). While the model of "homo-economicus" used by the agency theory manages opportunistic employees, the model of man used by the stewardship theory is trustworthy. While the former theory deals with monitor and control, the later deals with facilitating and empowering.

The need to achieve motivates managers, who obtain satisfaction by successfully performing a challenging work and by gaining recognition from peers and bosses. According to stewardship theory, there is no conflict of interest between managers and owners: managers are stewards that are aligned with the objectives of their principals Davis, Schoorman, & Donaldson (1997), so when designing the structure of corporate governance, coordination among team players is a key consideration –in contrast with the individualistic approach of the agency theory-. Since managers are stewards that act in the best interest of owners, the optimal organizational design should empower them and increase their autonomy (Donaldson, 1990).

The stewardship theory is based on the model of man that McGregor (1957) described in his "Theory Y": management is responsible for organizing resources, people are not by nature passive: in an analogue way to Say's Law in economics, where supply creates its own demand, employees may be idle not because of lack of interest, but because of lack of directions from management. The role of management is to arrange conditions so that employees and firms incentives are aligned, employees pursue their interest and simultaneously contribute to the firm's goals, in contrast with "Theory X", where management needs to closely organize and monitor employees, or else they would shirk their responsibilities. From the Stewardship Theory, manager's incentives converge with those of the corporation, so that self-esteem is aligned with corporate prestige. Future employment in the firm is a strong motivator. Managers want to do a good job, to be good stewards of corporate assets, so there is no intrinsic motivational problem (Donaldson & Davis, 1991).

The degree of power concentration –"leadership structure"- facilitates managers to execute their plans and is very relevant for manager's and firm's performance. If the CEO has complete authority over the firm, rather than being controlled by the board of directors, and her role is clear and free from interferences, CEO effectiveness will be higher. CEO duality, by concentrating in the same person the roles of top manager and chairman of the board, means a positive empowerment that results in better firm performance. In contrast with the Agency Theory, this approach consider that the CEO is not driven by financial incentives such as long-term compensation but to his natural motivation to do a good job. Donaldson & Davis (1991) found that, contrary to Agency Theory expectations, CEO duality is associated with higher returns to shareholders rather than an independent chair of the corporate board. Also, concentration of power means concentration of responsibility for possible failures, so empowered managers will have their reputation at stake, on top of legal liabilities, increasing their accountability and incentives to perform satisfactorily.

Although the Stewardship Theory has been considered by several authors opposed to the Agency Theory, both theories can be compatible. Even a key author for the development of the Agency Theory, such as Fama (1980:292), posits that "the manager of a firm, like the coach of any team, may not suffer any immediate gain or loss in current wages from the current performance of his team, but the success or failure of the team impacts his future wages, and this gives the manager a stake in the success of the team". Another example of compatibility is offered by Donaldson (1990) with takeover situations, where the stewardship approach will argue that managers perceive that not only they are threatened, but the very same corporation that can be restructured or loaded with debt, and that a new management team brought by the corporate raiders provide less expertise that incumbents have, so management opposition to the takeover does not necessarily imply an opportunistic behavior by management but an honest one. "Under conditions where the existing coalition between managers and owners is called into question, such as by a takeover threat, the interests of each party start to diverge; this is when agency theory may prove correct" (Donaldson, 1990:377). Davis et al. (1997) reconcile the Stewardship and the Agency Theory with a contingent model made up of psychological and situational factors. Regarding the former category, the people more likely to become stewards are those who are motivated by higher order needs, who have high identification with the organization and who are more likely to use personal power as a basis for influencing others. With respect to situational factors, people more likely to become stewards are those who are in an involvement-oriented -versus control-oriented- situation, who are in a collectivist culture and those who are in a low power distance culture –low acceptance that less powerful members will be dependent on more powerful members-. If both manager and principal adopt a stewardship relationship, firm performance is maximized; if a mutual agency relationship exists, firm costs are minimized and "if a mixed-motive choice exists, the party choosing stewardship is betrayed and the party choosing activity is opportunistic" (Shi, Connelly, & Hoskisson, 2017).

In summary, stewardship theory proposes an opposite view for managers than the agency theory does. Enriched by psychology and sociology, this theory relies not only to economic arguments for manager's incentives converging with those of the corporation–prestige and future employment- but to the very nature of man: executives are good stewards of corporate assets with a natural motivation to do a good job. CEO duality will be advocated by this theory, since it empowers the CEO and increases effectiveness, and without the focus on monitoring, no need for a majority of outside directors is derived from stewardship theory, that actually values the presence of inside director in the board, who far from compromising the board's effectiveness, add significant experience, facilitates contrasting of points of view with management and also provides extra motivation for the executives of the company. The stewardship theory contributes with an alternative model of man, but fails to offer an explanation for the abundant frauds and corporate scandals of the last decades. Table 5 summarizes the main conclusions of several theoretical and review papers that deal with corporate governance from the perspective of the Stewardship Theory.

Table 5. Corporate governance papers based on stewardship theory

Authors	Topic	Main conclusions
Donaldson (1990) (theoretical paper)	Organizational economics and management theory	• Organizational economics -based on agency theory-: managers shirk, deceitful, individualistic actors. Opportunistic behavior needs to be curbed by monitoring, incentives, promotions, negative sanctions. • Management theory based on stewardship theory. Managers are team players, the optimal structure is one that authorizes them to act, given that they will do it in the interest of owners • Stewardship theory may prove correct as long as the coalition between managers and owners persists. Under other conditions –i.e. takeover threat-, interests of each party start to diverge; this is when agency theory may prove correct
Davis et al. (1997) (review paper)	Stewardship theory of management	• Managers are more likely to become stewards for: o Psychological factors: those motivated by higher order needs, who have high identification with the organization and who are more likely to use personal power as a basis for influencing others o Situational factors: those who are in an involvement-oriented -versus control-oriented- situation, who are in a collectivist culture and those who are in a low power distance culture –low acceptance that less powerful members will be dependent on more powerful members- • If a mutual stewardship relationship exists, firm performance is maximized, if a mutual agency relationship exists, firm costs are minimized and if a mixed-motive choice exists, the party choosing stewardship is betrayed and the party choosing activity is opportunistic

2.4 Institutional Theory

We firstly describe the origins of the Institutional Theory to focus later on its application to corporate governance. Institutions have been said to be "humanly devised constraints that structure political, economic and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct) and formal rules (constitutions, laws, property rights)" (North, 1990:97). Institutions vary across countries and across time, therefore it is essential to analyze them to understand how they influence corporate governance: how the relationship between parties with a stake in the firm is affected. Roe (1994) explained how public mistrust of large corporations as well as interest group politics influenced on the fragmentation of financial institutions, dispersed ownership and stock-market finance in the United States, in contrast to bank-based forms of finance and corporate control in Germany and Japan.

The study of institutions and their influence on firms has reached a multidisciplinary approach. From a sociology perspective, the origins of institutions have been studied, taking into account culture, as a set of informal institutions –i.e. culture influences corporate law, impacting related party transaction regulation; Japanese executives focus on service to society and employees; U.S. executives focus on shareholder value creation, with the other stakeholders being secondary, German executives emphasize balancing the interests of employees and shareholders (Aguilera & Jackson, 2010)-. Other disciplines that have contributed to the development of Institutional Theory are: Political Science –studying the character and evolutions of institutional structures-, economics –that focuses on the constrains that institutions place on individual choices- and even psychology, where rules, leadership and even trust are analyzed to explain the individual willingness to forego self-interest (Zucker, 1987).

Let us briefly review the main literature developed over time on Institutional Theory. The institutional environment includes state legislation, rules, contracts, social norms, government administration, professional associations and codes. Overbeek, Apeldoorn, & Nolke (2007) points out the tendency of states to delegate power to private agencies in the fields of accounting and audit process as well as in the case of corporate governance. Under an institutional view, corporate governance is defined as "the whole set of legal, cultural and institutional arrangements that determine what publicly traded corporations can do, who controls them, how control is exercised, and how the risk and returns from the activities they undertake is allocated" (Blair, 1995:3).

This view of corporate governance as a set of legal, cultural and institutional arrangements constitutes an environment that heavily influences the firm activity. Selznick, who first described the impact of the institutional environment, defined the term cooptation as "the process of absorbing new elements into the leadership or policy-determining structure of an organization as a means of averting threats to its stability or existence [...] Cooptation tells us something about the process by which an institutional environment impinges itself upon an organization and effects changes in its leadership and policy" (Selznick, 1948:34). Not only the Institutional Theory uses this term, cooptation, the Resource Dependence Theory, concerned with the provision of environmental linkages, also use the "cooptation" concept. Another link with the resource dependence theory is that, institutionalization means compliance with laws and regulations, and lack of it may bring disruption in funding (Dimaggio & Powell, 1983). From a sociological point of view, Parsons (1956) analyzed the role that institutionalized systems played in legitimizing organizations' goals and mechanisms used to interact with society: (1) procurement of resources (2) decision making and (3) the institutional structure which integrates the organization with others

Meyer & Rowan (1977) described how formal organizational structures arise as a reflection of rationalized institutional rules inside firms, that function as myths which firms incorporate, gaining legitimacy, resources stability, and enhanced survival prospects. The use of these organizational structures that are legitimated by the environment makes economic sense because it implies responsible management, pleases external stakeholders -shareholders, clients, suppliers and the state- and avoids potential claims of negligence if something goes wrong. States play an important role through legislative and judicial authorities, by regulating several sectors –i.e. education, energy, transportation or healthcare- and granting licenses necessary to practice occupations. But firms' corporate governance does not adapt to their institutional contexts in a simple passive way, they also play active roles in shaping these contexts. This process may have adverse effects on operating or economic efficiency and it is possible to differentiate between organizations that are under strong output controls and institutionalized organizations that depend on confidence and stability achieved by isomorphism with institutional rules. Attempts to control and coordinate activities in institutionalized organizations lead to loss of legitimacy, so elements of the organization structure are decoupled from activities and from each other -hospitals treat, not cure; schools produce students, not learning-. The more an organization's structure is derived from institutionalized myths, the more it relies on confidence, satisfaction, and good faith.

Institutional structures derive from imitation of similar organizations or from structures embedded in the organization, by routines that improve organizational performance. If an innovation affects reputation and legitimacy, it is more likely to be adopted by the organization with uncritical acceptance (Tolbert & Zucker, 1983).

Institutionalization brings stability, resistance to change and low organizational failure. But the institutional environment does not interpenetrate every organization in the same degree. Zucker (1987) offers three complementary explanations for this asymmetric influence of the institutional environment: (1) internal goals and values – the more widely shared they are, the less likely it is to change them- (2) legitimacy of external control -organizations try to shape the institutional environment to legitimate their activities and obtain societal resources- and (3) power of the organization -“firms, with greater power than public organizations, use boundary units, contracting, or incorporating parts of the environment in internal hierarchies as means of reducing the effects on task performance of such environmental forces as suppliers and regulatory agencies” (Zucker, 1987):451. Lastly, if the firm performance is low, its shareholder will be more interested in outside interference.

As the process of organizational rationalization moves from the competitive marketplace to the state and the professions, organizations become more homogeneous through what Dimaggio & Powell (1983) names institutional isomorphism. Organizations compete not just for resources and customers, but for political power and institutional legitimacy. Dimaggio & Powell (1983) describe three mechanisms of institutional isomorphic change: (1) coercive isomorphism, from political influence and legitimacy (2) mimetic isomorphism, as a response to uncertainty and (3) normative isomorphism, from professionalization; and four predictors of this process: (1) degree of dependence on other organizations (2) degree of goal ambiguity of the organizations (3) degree of reliance on academic credentials and (4) degree of participation on trade and professional associations. Institutional definition or ”structuration” involves an increase in the information load with which organization must contend as well as in the interaction among organizations in the field, the emergence of inter-organizational structures of domination and patterns of coalition and mutual awareness among participants that they are involved in a common enterprise.

Eisenhardt (1988) makes an interesting comparison between the Institutional and the Agency Theory. In contrast with the agency theory, within institutional theory practices arise from imitation –from organization of information and risk bearing costs in agency theory-, the basis of organization is legitimacy -versus efficiency in agency theory-, people are viewed as legitimacy seeking -versus self interested rationalists in agency theory-, technology moderates the impact of institutional factors -versus organizations that should fit technology in agency theory- and legislation, traditions, social and political beliefs are independent variables in the institutional theory -versus outcome uncertainty, span of control and programmability in agency theory-. Lubatkin, Lane, Collin, & Very (2007) suggest an embeddedness framework for governance: while agency theory depicts social life as a "series of contracts between voiceless and neutral individuals", other social and cultural influences that are part of the "institutional environment" affect the firm's governance practices. Managers' propensity to act opportunistically and bounded rationality of principals change over time and firms continuously try more effective monitoring and incentive mechanisms. A firm's corporate governance is therefore influenced by the co-evolution of principals and managers' beliefs.

Friedland & Alford (1991) offered another approach to institutional analysis which posited institutional logics as defining the content and meaning of institutions. Society is analyzed in three nested levels: individuals, organizations and institutions. Institutions –capitalist market, bureaucratic state, democracy, family, religion- shape individuals and organizational interests. Because they are potentially contradictory, they offer different logics available to individuals and organizations, which transform the institutional relations of society by exploiting these contradictions. Institutions set the limits of rationality but individuals and organizations try to use institutional order to their own advantage. Sometimes rules and symbols are internalized and result in conformity, while in other occasions they are manipulated by different institutional logics to serve their purposes.

Institutions are conventionally understood as supraorganizational patterns of organizing social life rooted in shared norms (Friedland & Alford, 1991):242. But that definition underlines the exterior normative, leaving aside the interior order, that is why the authors propose a new approach that takes into account the relationship between symbol –the theoretical rules- and the practice executed by each organization. Society is constituted through multiple institutional logics […] Organizational behavior vary institutionally (Friedland & Alford, 1991:243). Organizations tend to be homogenous regardless of efficiency criteria, they adopt the appropriate forms as a way to access resources from other organizations which consider them to be legitimate.

Codes of corporate governance are a good example of the diffusion process described by the institutional theory. As markets develop, organizations must manage boundary-spanning interdependencies, the need for coordination increases and organizations adopt formal structures. This process is also driven by the penetration of political centers and rationalized myths that function as institutional rules through the educational system, social prestige, professions, programs, technologies, the courts, the law, stock market regulations, etc. Why do these formal structures diffuse? They do so because environments create boundary-spanning exigencies for organizations, and incorporating structural elements isomorphic with the environment help organizations to manage such interdependencies. Besides the traditional corporate governance mechanisms such as compensation, control by the board of directors or the market for corporate control, other factors influencing shareholding protection are ownership structure, the takeover market and the institutional framework. Codes of corporate governance belong, together with the legal system, to the institutional framework. Actually they complement the legal system, acting as a substitute for deficiencies in the protection of minority shareholders. Radical reform of the legal system is difficult but the adoption of codes is an affordable way to mitigate the legal system imperfections. Hard laws and soft regulations –as codes of good governance- are complementary. There is also a relevant interaction between hard and soft law: judges use the principles of codes as yardsticks to measure the specific conduct of directors and often part of soft law gets incorporated into corporate law (Zattoni & Cuomo, 2008). Most codes have recommendations on (1) balance between executive and non-executive directors ; (2) division of responsibility between the chairman and the chief executive officer; (3) information reported to the board; (4) procedures for appointment of new directors; (5) internal controls.

Corporate governance codes have very different roles across countries. There are significant differences across countries in the degree of investor protection. La-Porta et al (1998) assign 49 countries to four groups: common law countries, French civil law countries, German civil law countries, and Scandinavian civil law countries, and find that the laws in common law countries provide the strongest degree of protection for shareholders, while the laws in French civil law countries provide the least protection. While in common law countries judges can apply governance codes directly, it is not the case in civil law countries, leading to the risk of cosmetic adoption, since they can not be legally enforced. Cuervo (2002) compares the development of codes in the Anglo-Saxon and European countries: while in the former countries the reduction in the takeover movement in the 1990s contributed to an increase in institutional shareholder activism and demands for compliance with codes, in continental Europe they have been adopted to compensate for the lack of goof functioning takeover market. Both efficiency needs and legitimation pressures explain the diffusion of codes: efficiency needs in terms of shareholder protection and legitimation pressures in terms of liberalization, globalization and the presence of foreign institutional investors.

Table 6: Institutional framework and corporate governance

	Common law countries	**Civil law countries**
Ownership structure	Disperse	Concentrated
Main source of finance	Institutional investors	Banks and families
Shareholder protection	Very high	Depends on country
Managers incentives	Broadly aligned	Aligned with core shareholders
Board composition	Independent directors are majorities	Outside-proprietary and outside-independ majority.

Source: prepared by the author

Cuervo (2002) proposes that, for countries characterized by a large shareholder-oriented system, such as civil law countries, it is necessary to expand formal market control mechanisms to compensate for deficiencies in the legal system, rather than developing codes of good governance. In a similar vein, Aguilera & Cuervo-Cazurra (2004) analyzed a sample of 49 countries and found that codes of good governance are more likely to occur when a country lacks strong shareholder protection rights –as in the case of civil law countries-, when there is high government liberalization and a strong presence by foreign institutional investors and in countries with common-law legal system, more willing to continue improving their systems and to develop codes. Regarding the authors of the codes, they found that codes developed by governments and stock markets, and to some extent investors, have the strongest enforceability, in contrast to codes developed by professional associations, director associations, and management associations, since many of them are voluntary.

Codes may be similar across countries because of the influence of institutional investors and the recommendation of international organizations OECD (2004), but sometimes implementation of codes is made with scant consideration for country characteristics. The Russian code, published in 2002, does not address some of the most serious problems affecting Russia, which is attributed by Roberts (2004) to a public relations exercise with foreign investors. As Cuervo (2002) points out, for a code of good governance to be effective it must capture the socio-political and economic environment in which firms operate. Hermes, Postma, & Zivkov (2007) compared the codes of seven Easter European countries and found that on average they only cover around 50% of the recommendations published by the European Commission in 2003, a sign of the relevance of the institutional framework of each county: different regulatory system and business culture make a difference (Griffin, Guedhami, Kwok, Li, & Shao, 2017). Yoshikawa, Tsui, & McGuire (2007) showed that the majority of Japanese firms opted to preserve their traditional corporate governance system and that an increasing number of firms adapted the Anglo-American model to fit their own contexts. The authors highlight the value of adapting international standards stating that "creative imitation, which involves the modification and recontextualization of context-dependent norms and practices to fit the local context, is itself innovative" Yoshikawa, Tsui, & McGuire (2007): 976), in line with the idea of decoupling, as coexistence of institutional continuity and change (Meyer & Rowan, 1977).

Zattoni & Cuomo (2008) investigated whether the diffusion of codes of good governance in civil law countries is due to an honest intent to improve the efficiency of corporate governance or to "legitimize" the corporate governance practices of domestic companies in the global financial market, finding that the legitimation hypothesis prevails, in a consistent way with the symbolic perspective on corporate governance: diffusing practices are modified by adopters. They also found that civil law countries adopt codes later, issue a lower number of codes, and state more ambiguous and lenient recommendations.

But the Institutional Theory goes beyond hard law –civil vs common law systems- and soft law – codes of governance-. The institutional environment is also concerned with the social and cultural systems. Institutional theory emphasizes that organizations, organizational fields, and nations are more than a means to produce goods and services—they are also social and cultural systems. Judge, Douglas, & Kutan (2008) used institutional theory in their analysis of data from 50 countries between 1997 and 2005 to understand what the country-level predictors of corporate governance legitimacy might be. They found three institutional predictors of corporate governance legitimacy: (a) the greater the extent of law and order, (b) the more the culture emphasized global competitiveness, and (c) the less the prevalence of corruption, the higher the corporate governance legitimacy within a nation.

In civil law countries, and to a higher extent in emerging countries Ciftci, Tatoglu, Wood, Demirbag, & Zaim (2019), the corporate environment is characterized by a highly concentrated ownership structure that heavily influences corporate governance. While the agency problem – where agents are managers and principals are shareholders– is the framework for the first generation of corporate governance research –dealing with disperse ownership structures in the U.S. and U.K.-, there is a different conflict of interest that arises in emerging countries, where concentrated ownership is prevalent due to institutional difficulties to control these agents. In these countries, where the market for corporate control and securities laws do not contribute significantly to the control of agents, powerful controlling shareholders ensure that the agents act in the best interest of their principals. These shareholders are also called "blockholders", and are potentially able to influence the management of the firm due to the volume of their investment. So the conflict between agents and principals is mitigated by a concentrated ownership structure, since blockholders may be represented at the board of directors or exercise their voting power at the shareholders meeting, but a new conflict of interest arises between controlling shareholders and minority shareholders –the “principal-principal” conflict-. This may happen because of legal frameworks that allow to deviate from the one share one vote principle –i.e. dual-class shares Lund (2019)- or to extract rents from the firm through related party transactions. This very different institutional setting, typical of emerging economies, requires different mechanisms to ensure that minority shareholders are not exploited, this time by controlling shareholders, rather than by the firm’s management (Young et al., 2008). In these countries formal institutions -either absent or inefficient- are substituted by relational ties, business groups, family connections, and government contacts (Young et al., 2008):198). The relevance of the institutional theory for emerging countries expands well beyond corporate governance: it is also the dominant theory to explain management in these countries (Wright, Filatotchev, Hoskinsson, & Peng, 2005).

In summary the Institutional Theory has a dominant sociological and political perspective, and emphasizes that organizations and nations are more than means to produce goods and services—they are also social and cultural systems (Judge et al., 2008). As a consequence, organizations and their managers not only compete for resources but also seek for legitimacy. Therefore it is necessary to study the forces within the institutional environment that guide or constrain legitimacy seeking. These constraints and forces converge to create isomorphism, or similarity of structure within institutional environments, as described by (Dimaggio & Powell, 1983). In the case of corporate governance, companies have adopted voluntary recommendations regarding the functioning of their shareholder meetings and board of directors looking for legitimacy, but we wonder to which extent these measures respond to genuine will to protect shareholders or to what Meyer & Rowan (1977) called “myth and ceremony”. The institutional theory complements the principal-agent model in corporate governance with an external perspective that takes into account the legal, social and cultural factors that have an impact on the firm. It will not be possible to define the set of mechanisms that are optimal from a corporate governance point of view without taking into account the institutional environment of the firm.

Table 7: Summary of Corporate Governance Theories

	Agency Theory	Resource dependence Theory	Stewardship Theory	Institutional Theory
Main assumption	Need to control managers given misalignment with shareholders	Shareholders assume risks: high uncertainty about resource acquisition and the subsequent profitability of investments	Managers are good stewards of corporate assets with a natural motivation to do a good job	Organizations and their managers not only compete for resources but also seek for legitimacy
Directors' role	Monitoring	Link with the external environment, contributing to resource acquisition	Provide industry/firm experience, facilitate contrasting of points of view with management and provides extra motivation for executives	Monitoring Resource acquisition
Main authors	Shleifer & Vishny (1997) La-Porta et al. (2000b)	Pfeffer & Salancik (1978) Williamson (1984)	Donaldson & Davis (1991) Davis et al. (1997)	Meyer & Rowan (1977) Dimaggio & Powell (1983) Judge et al. (2008)

Chapter 3. Corporate governance and foreign investment

3.1 Introduction

Corporate governance has been broadly defined as the study of power and influence over decision making within the corporation and its study has been approached from different fields such as business, law, political science and sociology (Aguilera & Jackson, 2010). From a business point of view, corporate governance is a set of mechanisms through which shareholders protect themselves against expropriation by the insiders (La-Porta et al., 2000b). Therefore, two actors are at the center of corporate governance: insiders and shareholders. Who are the insiders? Managers who control the daily operations of the firm and may abuse their power to the detriment of minority shareholders. Relevant shareholders that are members of the board are also insiders and may influence the firm to extract rents from it, again to the detriment of minority shareholders. In order to mitigate this risk of minority shareholders' exploitation, firms implement internal corporate governance mechanisms, deciding on board of directors' composition and managerial compensation, while external mechanisms such as the legal and regulatory environment, are out of firms' reach (Arranz, 2015). The second kind of actors are all sort of investors, individuals and institutions, local and foreign ones.

Institutional investors channel the funds of individuals through pension and mutual funds. Specifically, foreign institutional investors have become very significant as foreign portfolio flows have increased in the world economy, particularly for countries in which domestic sources of finance are limited. Since the inflow of capital fosters firms' competitiveness, many governments have liberalized their capital accounts (Alonso, 2015).

While restricted capital markets discourage international investment, open capital markets contribute to efficient risk-sharing, lower cost of capital and increase corporate valuations (Chua, Eun, & Lai, 2007). Information asymmetries between shareholders and the firm's insiders hamper investment in listed companies but in the case of foreign capital, an additional home bias effect limits even further investment (Baik, Kang, Kim, & Lee, 2013). Although rational investors would diversify their assets holding a world market portfolio, in practice there are information asymmetries between domestic firms and international investors that may underweight foreign assets (Lewis, 1999).

Investors are more familiar with firms of their own nationality, that represent lower risks in terms of physical access for meetings with the management team, foreign currency risk, different accounting standards, cultural values and different legal systems -take over legislation, shareholder rights, voting procedures regarding compensation or related-party transactions etc. Investors may use foreign direct investment (FDI) to compensate for these risks, since FDI means holding control of the company and its management team. But that is not the case of pension and mutual funds, which build their diversified portfolios by acquiring stock of listed companies, without holding control of the companies where they invest, and therefore they need to overcome the asymmetries of information and distrust of managers that agency theory predicts (Fama & Jensen, 1983b). In other words, institutional investors face two challenges when they decide to invest in a publicly traded foreign company: the potential opportunism described by the agency theory and the foreign location of the company, due to the home bias effect.

Portfolio foreign capital may come close to FDI in terms of investor engagement and activism due to the incentives associated to the size of the equity stakes acquired and to investors' monitoring capabilities (Kim, Sung, & Wei, 2017). This leads firms to implement internationally accepted corporate governance practices to attract foreign capital (Chizema & Buck, 2006; Miletkov, Poulsen, & Babajide, 2014). Implementing these practices has its costs, but attracting foreign capital may also entail the reputational benefits associated to foreign institutional investors, in contrast with local investors, often perceived as less sophisticated and less-independent, holding ties with the firm (Zou, Tang, & Li, 2016). The majority of the literature on foreign capital attraction has not examined voluntarily adopted corporate governance mechanisms but exogenous factors that are not at firms' reach, or have focused on investors' preferences in terms of companies' financials Aggarwal, Klapper, & Wysocki (2005); Baik et al. (2013); Dahlquist & Robertsson (2001) or capital structure (Kim, Sung, & Wei, 2011; Leuz, Lins, & Warnock, 2009; Lins & Warnock, 2004). This paper will test the relationship between the voluntary adoption of corporate governance code recommendations and foreign capital attraction. This paper will contribute with the development of a theoretical framework that incorporates the home bias Lewis (1999) into the Agency Theory Fama & Jensen (1983a); Jensen & Meckling, (1976) to identify corporate governance mechanisms at firms' reach that may attract foreign capital, following (Abdul-Wahab, How, & Verhoeven, 2007; Goncharov, Werner, & Zimmermann, 2006). We will additionally analyze the moderating effect on the relationship between corporate governance code adoption and foreign capital attraction of two variables: the international diversity at the board of directors and the presence of a controlling shareholder. International diversity may affect the effectiveness of corporate governance mechanisms to attract foreign capital. Since Jensen & Meckling (1976) highlighted the need of board independence to control managers, corporate governance literature has elaborated first on board composition –inside versus outside directors Dalton et al. (1998), later on board demographics such as gender Campa & Zijlmans (2019), age, race and ethnicity Erhardt, Werbel, & Shrader (2003) and recently on foreign nationality (Hahn & Lasfer, 2016; Masulis, Wang, & Xie, 2012). Foreign directors are for example not included yet among the 64 recommendations of the Good Governance Code of listed companies issued by the stock market supervisor in Spain in 2015. But both the home bias effect and the potential opportunism by managers may be less of a threat for foreign investors if the board of directors has an international composition. Foreign directors bring not only the enhanced independence that may be attributed to them, but also prestige and international skills. The management team will be used to report to the board in an international way, and therefore will find it easy to communicate with international investors, helping them overcome the home bias. We will contribute examining the relationship between foreign directors and the participation of foreign capital in capital market transactions. The presence of a controlling shareholder poses a potential “principal-principal” conflict, which requires mechanisms to ensure that investors are not exploited, this time by controlling shareholders, rather than by the management (Young et al., 2008).

Therefore, we will analyze the moderating effect that the presence of a controlling shareholder means for the relationship between corporate governance and the probability of attracting foreign capital. Lastly, we contribute by designing corporate governance indexes after a thorough analysis of the recommendations included in the three Spanish Codes of Good Governance that have been in force during the last eight years. Annual filings of corporate governance allow us to benefit from data whose consistency has been revised by the stock market supervisor. We find evidence of a positive relationship between the degree of code adoption at the firm level and the volume of foreign funds attracted by the firm. With the support of factor analysis, we select and weight 16 recommendations whose adoption increase the probability of attracting foreign capital. We also find that the presence of a high proportion of foreign directors is a strong incentive for foreign investors to participate in capital market transactions.

3.2 Home bias, information asymmetries and opportunism faced by foreign investors

Different definitions of corporate governance point to a common goal: to protect investors. In this vein corporate governance is said to deal with “ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" (Shleifer & Vishny, 1997). Corporate governance is also defined as a set of mechanisms through which outside investors protect themselves against expropriation by the insiders" La-Porta et al. (2000b) or "is set to prevent that groups with more bargaining power extract rents from groups with less bargaining power in the case of an incomplete contract" (Arranz, 2015):96. But who are these insiders and why should they threaten investors? Both managers and relevant shareholders that are members of the board of directors can exert a direct influence on the company and divert assets to themselves through a practice called "tunneling" (Johnson, La-Porta, Lopez-de-Silanes, & Shleifer, 2000). Shareholders reasonable fear that they will be in the dark about such a practice, that insiders will take advantage of the informational edge that they enjoy. Most definitions of corporate governance share two assumptions: the existence of relevant information asymmetries between insiders and minority shareholders and the potential for opportunistic behavior on the part of insiders, that is, managers and relevant shareholders represented at the board. As predicted by the agency theory, the separation of ownership and control, along with the informational disadvantage of shareholders versus managers, pose a risk for shareholders: will their funds be expropriated or wasted by managers, who hold inside information and far more data? (Fama & Jensen, 1983a; Jensen & Meckling, 1976). On top of the information asymmetry, and connected to it, there is a divergence between agent's and principal's interests: shareholders will maximize dividends and stock prices while managers will prefer growth: empire building will bring them higher salaries and prestige. Although the principal will set limits to the agents' discretion to allocate funds, managers will end up with significant discretion for self-interested behavior, since principals will often lack information or expertise to decide in unexpected situations, the very reason why agents are hired (Shleifer & Vishny, 1997). Since managers are holders of inside information and might abuse it to their own advantage, corporate governance may contribute by setting up mechanisms that reduce the potential for opportunistic behavior. In the case of foreign investors, information symmetries are more pronounced Choe, Kho, & Stulz (2005); Kang & Kim (2010); Zou et al. (2016), therefore foreign capital will particularly require the existence of corporate governance mechanisms prior to its entry into the company's capital. Firms reaching out for foreign capital face an additional burden: the home bias effect (Ahearne, Griever, & Warnock, 2004; Kho, Stulz, & Warnock, 2009; Lewis, 1999). Investors do not properly hedge risks across countries, they tend to hold too little of their wealth in foreign assets in comparison with what would derive from a rational diversification, consistent with which the proportion of foreign assets in investors' portfolio would equal the proportion of existing foreign stocks (Levy & Sarnat, 1970; Markowitz, 1952). This home bias effect exists even at the domestic level: within the same county, fund managers have a strong preference for local stocks, being geographic proximity a relevant factor for stock selection (Kang & Kim, 2008). Investors near a firm have an information advantage, possibly due to easier access to information about the firm through informal talks with management and visits to the company facilities. Proximity is relevant not only for stock selection, but also for the degree of involvement in corporate governance after investing –e.g. presence in the board of directors or replacing of management- Although there is evidence that the home bias effect reduces the investment on foreign assets below the levels that rational diversification would dictate- Ahearne et al. (2004); Kho et al. (2009), controversy still exists about the theoretical explanations for domestic investors not acquiring more foreign assets (Lewis, 1999). The information asymmetries between foreign and domestic investors are, together with barriers to international investments and optimism of domestic investors toward home assets, among the reasons identified by Ahearne et al. (2004) to understand the home bias effect. A sensitive example of these information asymmetries can be found in the heterogenous quality of financial information across countries. A firm with a US listing will produce higher quality financial information and reduce information costs, since it will adopt US accounting standards, disclosure requirements and regulatory environment. The proportion of firms with a public US listing -as a proxy for the reduction in information asymmetries in a country- strongly influences the country's ability to attract US investors (Aggarwal et al., 2005). Also, firms' ownership structure affects the home bias effect: in countries with high capital concentration, the home bias tends to be stronger, since a high proportion of shares is held by domestic relevant shareholders. Therefore, foreigners tend to invest in firms with a disperse capital structure which in turn avoids the risk of expropriation of assets by controlling shareholders. In countries with a high presence of significant shareholders, investor protection is more effective than the removal of barriers to international trade to attract foreign investors (Dahlquist, Pinkowitz, Stulz, & Williamson, 2003). Foreign investors will also avoid companies with an ownership structure where there is a divergence between ownership and control rights –companies with dual-class shares, pyramid shareholding structures or cross shareholdings-, since a controlling stake can be achieved regardless of the ownership structure (Claessens, Djankov, Fan, & Lang, 2002; Kim et al., 2011). By assuming that unknown stocks are riskier Merton (1987), information asymmetries would reduce foreign investment: investors would buy stocks from the same country because they know domestic firms better than international ones. Investors might perceive that foreign stocks will be expensive and difficult to monitor and this leads investors to underweight foreign stocks, buying instead some inferior local stocks (Baik et al., 2013; Bell, Filatotchev, & Rasheed, 2012; Zaheer, 1995). Foreign investors are less informed than domestic investors about domestic firms in the host country and must bear extra costs to compensate for this asymmetry -e.g. collection of information, travel expenses, etc.-.

The extent of this asymmetry depends on the physical distance between the investor and the firm, the track record investing in the host country, the difference in shareholder protection and the existence of language and cultural differences (Kang & Kim, 2010). Firm's degree of digitalization may mitigate the effect of physical and cultural distance on foreign investment attraction Nylén & Holmström (2015). Companies experience a transformation of their processes as a consequence of the digitization of the work environment Morabito (2014). Digital technologies not only foster product and service innovation but bring closer foreign investors and firms that may be far away both in physical and cultural terms.

The extra-monitoring costs caused by the information asymmetry limits foreigners involvement in governance to companies where the benefits from their monitoring activities are expected to be large -i.e. targets can achieve high free cash flows –. Choe et al. (2005) and Zou et al. (2016) found that domestic institutional investors have an edge in stock picking skills over foreigners. The authors identify several preferences of foreign institutional investors that point to the information asymmetry they suffer: they tend to hold firms with longer history, bigger size, lower leverage, greater accounting transparency and cross-listed in the US (Zou et al., 2016).

Foreign investors reaching out to international capital markets need to overcome higher information asymmetries and monitoring costs Hou & Lee (2014); Leuz, Lins, & Warnock, (2010), compounded by the existence of language and cultural differences (Kang & Kim, 2010). Companies seeking foreign capital need to overcome information asymmetries by adapting to broadly accepted corporate governance practices across countries Chizema & Buck, 2006; Miletkov et al. (2014), such as board independence, transparency and cooperation with financial analysts. Both board independence, that ensures control on behalf of finance providers Miletkov et al. (2014); Neupane & Neupane (2017); Suchard (2009), and transparency Aggarwal, Erel, Ferreira, & Matos (2011); Aggarwal et al. (2005); Broberg, Tagesson, & Collin (2010); Bushee & Noe (2000); Ferreira & Matos (2008), are particularly relevant in companies with dispersed shareholders and exposed towards foreign investors. The importance of information asymmetries for foreign investors is shown by the strong relationship found between transparency and exposure to the international capital market (Deeg & Perez, 2000; Gray, Meek, & Roberts, 1995; Holm & Schøler, 2010; Oxelheim & Randøy, 2003).

Transparency is also improved by the breadth of financial analysts' coverage. The higher the number of analysts that follow a company, the smaller the relevance investor assign to the firm's corporate governance mechanisms (Chung & Zhang, 2011). This is not only because analysts help reduce information asymmetries by devoting time and resources to interviewing managers and analyzing financial information, but also because analysts take into account for their investment recommendations firm's corporate governance mechanisms (Gillan & Starks, 2003). We would therefore expect investors to pay less attention to the corporate governance of a company covered by many analysts, since this means higher firm transparency. In a nutshell, the agency problem is compounded by the home bias effect in the case of foreign investors, who will prefer to invest within their own countries rather than carrying out the necessary and expensive monitoring process associated not only with a minority stake at a public company -agency problem- but with a company headquartered abroad –home bias effect-. In this context, corporate governance mechanisms come as an alternative to expensive and time-consuming monitoring that foreign investors face. Physical and cultural distance, extra costs related to traveling, difficulty to meet and access the management team and the difference in shareholder protection increase the risk of opportunistic behavior.

Kang & Kim (2010) argue that foreign investors are less informed than domestic investors about domestic firms in the host country and must bear extra costs to compensate for this asymmetry -e.g. collection of information, travel expenses, etc.-. The extent of this asymmetry depends on the physical distance between the investor and the firm and the track record investing in the host country. If a firm has in place corporate governance mechanisms, foreign investors have an incentive to overcome the home bias, since corporate governance mechanisms reduce the enlarged information asymmetries and potential for opportunism that they face.

3.3 Codes of corporate governance adoption and cross border fundraising

Codes of good governance are a “set of best practice recommendations regarding the behavior and structure of the board of directors of a firm. They have been designed to address deficiencies in the corporate governance system by recommending a comprehensive set of norms on the role and composition of the board of directors, relationships with shareholders and top management, auditing and information disclosure, and the selection, remuneration, and dismissal of directors and top managers” (Cuervo-Cazurra & Aguilera, 2004:419-420). These corporate governance codes are “soft law” and companies are only obliged to report whether they decide to follow each of the recommendations, increasing their accountability to shareholders. Research on codes of corporate governance has shown codes are a complement to national laws and regulations. Aguilera & Cuervo-Cazurra (2009) undertook a study of 49 countries, founding that codes of good governance are more likely to occur in countries without strong shareholder rights, with high government liberalization and with greater foreign investment exposure. In a similar way that exposure to foreign investment has been found connected to codes diffusion at the country level, it seems reasonable to expect a positive relationship between the degree of code adoption at the firm level and the volume of foreign funds attracted by the firm.

Convergence towards the Anglo-Saxon model of corporate governance has underpinned codes of corporate governance diffusion (Aguilera & Cuervo-Cazurra, 2004). Since global investors face multiple laws and regulations in each of the countries where they invest, and codes are designed across countries towards convergence with the Anglo-Saxon model Drobetz & Momtaz (2019), codes offer international investors a standard measure of the quality of corporate governance of local companies. Companies must disclose the degree of compliance with the recommendations of the code, and the national stock market supervisor verifies that this reporting adheres to the code’s structure and definitions, facilitating monitoring for international investors, who can easily verify the proportion of code recommendations that a company follows to gauge its overall corporate governance. As long as a firm follows a high percentage of the total number of code recommendations set up by the national supervisor, investors attracted to a foreign stock will count on an additional reason to buy it in spite of the home bias, overcoming the enlarged information asymmetries and potential opportunism they face. Codes share a standard body of recommendations appreciated by international institutional investors -i.e. board independence from management, procedures for director nomination and dismissal, executive compensation, relationships with shareholders and top management or auditing and information disclosure- but are also adjusted in each country to include specific recommendations suited to complement local laws and regulations -i.e. recommendations for companies' bylaws regarding takeover provisions or disclosure of information and procedure to facilitate participation at the shareholders' general meeting-.

Therefore, firms adopting most of the recommendations included in a code mitigate the home bias that foreign investors face in a double way: firstly, by strongly signaling the adoption of internationally recognized corporate governance mechanisms. Compliance with a code of good governance works as a "quality seal" that can partially compensate for the challenges associated with investing abroad -access to management is more expensive, accounting standards may differ and trading is done at a disadvantage with local investors, who are more familiar with the company and do not suffer any cultural difference (Choe et al., 2005).

Secondly, adopting these recommendations provides foreign investors with some assurance that the shortcomings of corporate bylaws and domestic regulations are compensated with provisions of the code designed with that goal -i.e. voting rights are not limited to prevent take overs. Lastly, codes of good corporate governance are isomorphic cross-nationally (Dimaggio & Powell, 1983). Codes include recommendations that are widely shared across countries, and therefore their adoption bring legitimation Tolbert & Zucker (1983) to the local firms that need to reassure foreign investors to overcome the home bias. This search of legitimation could impair codes compliance significance if they are approached with a box-ticking exercise, decoupled from a transformation in the firm's corporate governance culture (Aguilera, 2005). Firms may overstate compliance with corporate governance codes under pressure to gain legitimacy, with lax interpretations of the recommendations contained in the codes -i.e. the classification of a director as "independent"-. The scrutiny of corporate governance reports by stock market supervisors and proxy advisors mitigates this risk.

Most of the recommendations included in corporate governance codes deal with the board of directors, the committees set up by the board, and a variety of specific issues regarding directors' selection, dedication and compensation. These three categories share two values: board independence -the capacity of the board to control managers- and transparency -the mechanisms aimed at reducing the information asymmetries between insiders and minority shareholders- We review board independence and transparency in turn. Board independence allows to effectively control management on behalf of investors. This corporate governance mechanism has been found to be positively associated with foreign investment (Miletkov et al., 2014; Neupane & Neupane, 2017).

While local investors may have business relations with the firms they invest in and be loyal to their managers, foreign investors are more independent and are used to challenging management and pushing for governance improvements Kim et al. (2017), making use of their superior monitoring skills (Aggarwal et al., 2011). Board independence ensures the effective control of management, which would not be possible with a significant presence of executives at the board. When investors are not represented at the board, the very existence of board directors responsible for setting the right incentives for managers, providing them with advice and monitoring their decisions is an essential corporate governance mechanism. When managers are not efficient, directors will replace them to improve performance. Management control through an independent board will be particularly useful to compensate for the increased information asymmetries that foreign investors face (Holm & Schøler, 2010).

Independence of the board from the firm's managers can be reached through a majority of independent directors, less biased and better prepared to judge manager's performance and protect shareholders (Hu, Yian, & Ziao, 2014; Lynall et al., 2003). But directors that represent shareholders with a significant stake - "proprietary directors" - can also effectively control managers: significant shareholders have invested large amounts of funds into the firm and have strong incentives to monitor and control management. If a single investor is represented at the board with a controlling number of proprietary directors, he will control the management team and could eventually make decisions to the detriment of minority shareholders. But if a group of different shareholders are represented through proprietary directors at the board, they will control each other so that none of them abuses his position in detriment of minority shareholders. And all proprietary directors, together with independent directors, control management. In summary, board independence from the firm's managers can be achieved through independent directors and proprietary directors that represent different investors. Foreign investors, with diversified portfolios that seldom allow them to appoint their own proprietary directors, will find independent boards as a powerful tool to control local management teams, instead of the more expensive and complex direct monitoring from abroad.

The relevance of transparency for foreign investors is better understood when considering how the home bias compounds the agency problem. Foreign investors not only face information asymmetries with the managers of the companies where they invest, they are also at an informational disadvantage with local investors. The home bias increases the importance of the extent to which firms voluntarily disclose information (Elshandidy & Neri, 2015). The bigger is the information asymmetry, the higher will be the need for transparency, which makes transparency paramount for foreign investors. This kind of investors suffers not only cultural or linguistic differences, but a simple physical distance that cause higher monitoring costs associated to different accounting standards, travel expenses for management meetings and visit to facilities. Among the information asymmetries faced by foreign investors are particularly relevant those owed to poor quality and low credibility of financial information in many countries (Ahearne et al., 2004). To compensate for this, firms may list themselves in the US by issuing American Depositary Receipts (ADRs). Alternatively, firms might increase their disclosure level beyond what is mandatory (Gyapong, Godfred, & Afrifa, 2018; Mallin & Ow-Yong, 2012) . Increasing the level and quality of disclosure may attract foreign capital (Deeg & Perez, 2000; Gray et al., 1995; Oxelheim & Randøy, 2003). Higher quality disclosure is preferred by institutional investors as a way to offset monitoring costs (Bushee & Noe, 2000; Enache & Hussainey, 2019).

Lastly, we must consider that institutional investors, particularly suited to do so, channel most foreign investment Zou et al. (2016), so drivers of institutional investment are also meaningful for understanding foreign investment. Institutional investors often hold large portfolios with a high number of stocks and relevant monitoring costs. A high degree of transparency not only reduces the costs associated to monitoring but is also useful for reducing the probability of fraud, a requirement of institutional investors with fiduciary responsibilities (Schmidt & Fahlenbrach, 2017). They also build large stakes in the company where they invest and a rapid sell off due to a corporate governance failure would cause large losses (Bushee, Carter, & Gerakos, 2014). Chung, Elder, & Kim (2010) find that corporate governance mechanisms improve stock market liquidity and lower trading costs, therefore facilitating the unwinding of large positions held by institutional investors. Based on the above arguments, we propose the following hypothesis:

Hypothesis 1: *Firms that follow corporate governance code recommendations increase their probability of attracting foreign capital*

Codes of good governance have diffused internationally at a rapid pace, especially following the Cadbury Commission's report in the United Kingdom (1992), with a general consensus for recommendations on board independence and transparency (Cuervo-Cazurra & Aguilera, 2004). Other recommendations were considered at a later stage, such as board diversity in terms of gender, age, race and ethnicity Erhardt et al. (2003) and not until recently foreign nationality (Hahn & Lasfer, 2016; Masulis, Wang, & Xie, 2009). Although board diversity in terms of nationality is not a corporate governance recommendation across countries, the proportion of board members that come from countries different to the nation where firm is headquartered is related to the firm's capacity to gain foreign investors' confidence (Cumming, Filatotchev, Knill, Reeb, & Senbet, 2017). If the board has an international composition, the management team will be used to report to the board in an international way, and we can argue that management will find it easy to communicate with international investors, improving form's ability to tap foreign capital.

It has been argued that directors that are domiciled abroad have lower board attendance Masulis et al. (2012) and that firms where their proportion of international board members is high decrease their meeting frequency (Hahn & Lasfer, 2016). Nevertheless, that is only true if foreign directors reside abroad and must travel internationally for each board session. On the other hand, it can be expected that foreign directors contribute to reduce information asymmetries associated with cultural and linguistic differences that contribute to the home bias experienced by foreign investors. The presence of foreign directors at the board helps bridging the cultural gap, even if those directors do not share the nationality of the investor, by improving decision making and reducing group-thinking, since foreign director have diverse educational, cultural and working experience. Also, the company will be forced to report to its board in an international way, so that it does not take a local to understand and approve the issues discussed. A board of directors opened to foreign directors' signals endorsement by non-locals, encouraging foreign investors. Foreign investors are more independent from the firm than local investors, and they use their superior monitoring skills to control management (Aggarwal et al., 2011; Carter, Simkins, & Simpson, 2003; Van-der-Walt & Ingley, 2003). Foreign investors will value independent boards, as they allow to control local management teams, instead of the more expensive and complex direct monitoring from abroad. Also, foreign directors are less networked to the domestic business society, and they have lower probability of local interlocking directorships, being able to dedicate more time to monitor the company (Ruigrok, Peck, & Tacheva, 2007). Besides the potential benefits of foreign directors in terms of management control, we must also consider that directors also serve as a link with the external environment, contributing to resource acquisition. Directors allocate their attention to various functions such as resource provision, environmental scanning and opportunity seeking (Tuggle et al., 2010). Several factors are a source of uncertainty and external dependencies that directors can help to mitigate , such as availability of capital, regulatory environment and new technologies (Pfeffer & Salancik, 1978). Moreover, the access to valuable resources increases firm legitimacy by enhancing the reputation and credibility of their firms. The extent to which directors benefit the firm depends on whether their membership of the board provides access to valued resources and information, reduces environmental dependency, or aids in establishing legitimacy (Daily & Dalton, 1994; Daily & Schwenk, 1996; Hambrick & D'Aveni, 1992).

From this perspective, foreign directors provide higher advisory capabilities that can contribute to increase the level of confidence of foreign investors, helping them overcome the home bias. Among these capabilities are knowledge of foreign markets Carpenter, Sanders, & Gregersen (2001), region specific expertise valuable for cross-border acquisitions Masulis et al. (2012) and a positive reputation in the international financial market (Oxelheim & Randøy, 2003). Since foreign investors usually come from developed economies, their reputation and financial skills will strongly contribute to improve the company quality of financial reporting, result in better access to credit Koo & Maeng (2006) and it might contribute to increase the confidence that foreign investors require to participate in IPOs/capital increases conducted by the firm. Therefore, we establish the following hypothesis:

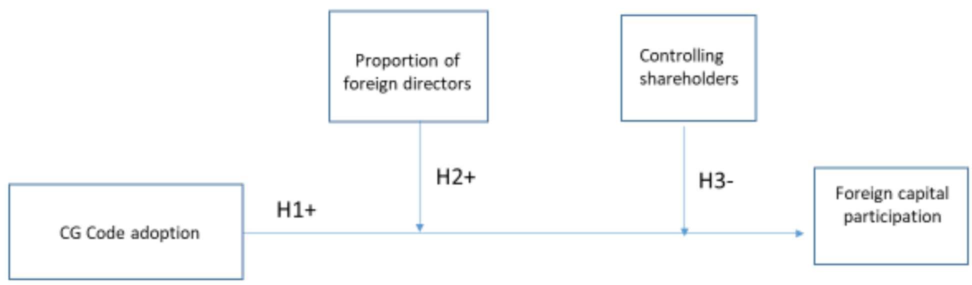
Hypothesis 2: *The proportion of foreign directors at the firm's board reinforces the positive relationships between adopting corporate governance code recommendations and the attraction of foreign capital*

The existence of controlling shareholders also influences the home bias experienced by foreign investors. Firms with controlling shareholders have a lower number of shares available for the entry of a foreign investor. Dahlquist et al. (2003) studied 51 countries and found that, on average, 32% of shares were not available for trading because of belonging to controlling shareholders, usually local investors. If an average country with 32% of shares under controlling shareholders represents for example 5% of the world stock market capitalization, the home bias would be over 6 times. Since a significant fraction of companies is held by local controlling shareholders, foreign investors will tend to invest in less closely held companies, with a more dispersed capital structure (Ferreira & Matos, 2008; Leuz et al., 2009). And even if enough capital is available –i.e. by the issuance of new shares at IPOs and capital increases - foreign investors still face the risk of expropriation of assets by local controlling shareholders. Controlling shareholder can effectively control management La-Porta et al. (1998), therefore mitigating the conflict between agents and principals. But a new conflict of interest arises between controlling shareholders and minority shareholders –the "principal-principal" conflict (Young et al., 2008). An extreme case of this situation are family-controlled groups in emerging countries, where management is frequently a member of the controlling family Aguilera & Haxhi (2019)–or appointed by it-, who pursue significant private benefits of control (Peng & Jiang, 2010a). The expression "controlling shareholder" does not refer to a majority stake in the capital but to a number of shares that suffices to ensure control, with La-Porta, Lopez-de-silanes, & Shleifer (1999) and Faccio & Lang (2002) considering 20% of capital as the controlling threshold. A controlling shareholder with over 20% of capital will be represented at the board of directors therefore exerting a significant influence on the firm decision making, which increases the risk of the firm making business that benefits controlling shareholders.

Companies may finance their expansion projects through capital increases underwritten by their controlling shareholders but when additional capital is needed it frequently comes from abroad (Cuomo, Zattoni, & Valentini, 2012). The presence of a controlling shareholder may be a deterrent for foreign investors, unless there is other relevant shareholder and both monitor each other Pagano & Roell (1998), and all of them effectively control managers on behalf of minority investors. We assume that monitoring the controlling shareholder does not require a stake as large and will follow La-Porta et al. (1999) to consider 10% stakes as sufficient for "controlling shareholders monitoring". Companies adhering to a code of good governance or incorporating foreign directors to the board send a reassuring signal to foreign investors who will perceive these measures as an incentive to buy foreign stock in spite of the home bias. But this incentive will be impaired by the presence of a controlling shareholder that is not subsequently monitored by another relevant shareholder. Based on that, we establish the following hypothesis:

Hypothesis 3: *The presence of controlling shareholders reduces the positive relationships between adopting corporate governance code recommendations and the attraction of foreign capital*

Figure 1: Model proposed



3.4 Data

The aim of this research is to evaluate the relationship between corporate governance adoption and the attraction of foreign capital. More precisely, we try to understand how corporate governance affects the decision of foreign capital to participate in capital market transactions-. We have constructed a sample of capital market transactions where corporate governance is particularly relevant for foreign investors: capital increases and IPOs. We will analyze capital increases and initial public offerings (IPOs) since the new shares issued at these transactions finance new businesses or the expansion of the existing business to new markets, products or technologies. In contrast with the ordinary trading of shares in secondary markets, the acquisition of new shares issued in these transactions means fresh money being invested by the firm. Corporate governance is particularly relevant in these transactions: information asymmetries are higher since the company does not have a track record in the capital market – in the case of IPOs- or assumes the risk associated to a new investment –in the case of capital increases-. As shown by Inci, Lee, & Suh (2009), there is a causality link between corporate governance and the profitability of capital investment, which confirms the relevance of corporate governance for these transactions. In these transactions information asymmetries are higher than those associated to the ordinary trading of existing shares in the market. These transactions involve the issuance of new shares to the market to finance new investment projects –in the case of capital increases- or to allow investors to participate in an IPO -which also imply a higher risk associated with a company without a track record in the capital market-. These characteristics of the IPOs make them especially suitable to the test our research since foreign investors face higher information asymmetries Choe et al. (2005); Kang & Kim (2010); Zou et al. (2016) and these transactions add an extra-layer of asymmetry, making corporate governance particularly useful to mitigate information asymmetries. More precisely, we have used a sample of capital market transactions undertaken by public companies whose headquarters are at the same country, Spain. In this vein foreign investors' firm choice will not be affected by the institutional frameworks of different countries and we will be able to identify corporate governance mechanisms at the reach of shareholders rather than external corporate governance factors such as the legal system and the strength of the institutional environment (Djankov, La-Porta, Lopez-de-Silanes, & Shleifer, 2008; Hail & Leuz, 2006; Jackson & Roe, 2009; La-Porta, Lopez-De-Silanes, & Shleifer, 2006)

Data were obtained with the cooperation of the Spanish Stock Market Supervisor, who provided us with information on capital increases and initial public offerings conducted during the period 2010-2017. The limited size of the Spanish equity capital market makes it necessary to gather data from several years, since a sample large enough cannot be constructed with the capital increases and IPOs of a single year. We have chosen the last 8 available years (2010-2017) so that enough data are gathered, and the last 3 corporate governance codes are represented in the sample. For the period 2010-2017, the number of listed companies in Spain ranged from 139 (in the year 2017) to 153 (in the year 2010). Out of these firms, 96 conducted initial public offerings or capital increases in the 2010-2017 period, and after excluding financial companies due to their special accounting system and regulation, the final sample has 76 companies.

As can be seen in table 8, 2012 is a special year during which the situation of the Spanish capital market was critical due to the financial assistance – "rescate"- requested by the Spanish government on June 2012. We have gathered data for the total of funds raised and the volume of funds provided by foreign investors for IPOs and capital increases -excluding those that do not involve funding, such as capital increases to pay dividends or to be distributed free of charge among shareholders-, totaling 401 transactions conducted during 2010-2017. Although our sample combines both capital increases and IPOs, other studies that have focused on IPOs have used samples of comparable size: Neupane & Neupane (2017) and Suchard (2009) samples comprise 377 and 522 transactions respectively.

Table 8: Transactions by year: total investment versus foreign participation

	Number of transactions	Total investment (€ million)	Foreign investment (€ million)	% foreign
2010	38	13,041	7,970	61%
2011	47	12,712	6,886	54%
2012	33	1,152	112	10%
2013	67	1,794	1,203	67%
2014	71	7,694	5,299	69%
2015	56	16,097	12,597	78%
2016	40	5,526	3,369	61%
2017	49	11,914	9,308	78%
Total	**401**	**69,931**	**46,745**	**67%**

Dependent variable: Attracting foreign investors

Abundant research have studied the home bias effect that make investors reluctant to invest abroad Ahearne et al. (2004); Kho et al. (2009) and the influence of country's specific factors, such as the legal system, to attract foreign investors (Djankov et al., 2008; Hail and Leuz, 2006; Jackson and Roe, 2008; La-Porta et al., 2006). At the firm level, the extant literature has examined the relationship between corporate governance and foreign investment measuring the later with the percentage of total capital held by foreigners (Dahlquist & Robertsson, 2001; Leuz et al., 2009; Lins & Warnock, 2004; Miletkov et al., 2014). This is a static approach which involves a limitation: we may find a positive relationship between corporate governance and foreign investment at a given point in time but we do not know if corporate governance was good before foreigners invested in the firm or if corporate governance improved after their entry (Broberg et al., 2010; Garner & Kim, 2013). The fact that we measure the state of corporate governance at the precise year when foreign investors decide whether to participate or not in capital market transactions allow us to better analyze causation between corporate governance and foreign investment. We measure our dependent variable with a binary variable that equals to "0" for those transactions which do not attract any foreign capital and "1" for those which succeed in attracting foreign capital in spite of the home bias and information asymmetries they face.

Independent variable: Corporate Governance

Our independent variables measure the corporate governance mechanisms that these companies had implemented prior to the initial public offerings and capital increases. Rather than focusing on certain corporate governance mechanisms, such as proportion of non-executive directors Neupane & Neupane (2017), CEO duality Bushee et al. (2014); Miletkov et al. (2014) or degree of transparency Broberg et al. (2010) we try to assess the overall compliance with the comprehensive set of recommendations included in corporate governance codes. This global approach to measuring corporate governance allows investors to gauge corporate governance in a comprehensive way and allows firms to understand the relevance of the whole set of corporate governance mechanisms at their reach so that they may discriminate for their implementation. We analyze compliance of every company to the provisions included in the corporate governance code, in line with (Ararat, Black, & Yurtoglu, 2017; Goncharov et al., 2006) and benefiting from the standardized corporate governance reporting that all Spanish listed companies are obliged to file with the stock market supervisor.The Spanish corporate governance is measured by the Good Governance Code of Listed Companies has three different versions during our period of analysis: it comprises 58 voluntary recommendations during 2010-2012 CNMV (2006), 53 during 2013-2014 CNMV (2015) and 64 during 2015-2017

CNMV (2015), according to the comply or explain principle. Therefore, companies decide whether to follow corporate governance recommendations but must provide an explanation when they decide not to follow a recommendation. Moreover, companies must disclose an annual corporate governance report in which they specify their degree of compliance with every recommendation of the code. The Spanish stock market supervisor reviews the reports to check that the definitions of the code have not been manipulated -i.e. criteria for independent directors- and ensure that, where a recommendation is not followed, an explanation has been provided so that investors can form their judgement. We have reviewed compliance for the 53-64 recommendations -depending on each of the three codes- by each of the companies that conducted the 401 transactions in our sample and by the time those transactions were executed. More precisely, companies report to the stock market supervisor if they (1) comply with the recommendation, (2) explain why they decide not to comply or (3) partially comply. When a recommendation does not apply (i.e. recommendation regarding listed subsidiaries when the company does not have any listed subsidiary) the company does not even have to provide any information, so this is equivalent to compliance, since the company has avoided the potential problem that the recommendation was trying to mitigate. We have assigned a value of “1” for compliance, “0.5” for partial compliance and “0” for non-compliance. Indexes in the extant literature are built on a previous selection of corporate governance items compiled by private vendors such as the Investor Responsibility Research center (IRRC) or ISS-RiskMetrics (Aggarwal et al., 2009; Bebchuk, Cohen, & Ferrell, 2009; Gompers, Ishii, & Metrick, 2003). While they are of great interest, in this research we designed corporate governance indicators building on the items included in the three codes in force during 2010-2017. In doing so our analysis builds on the extant literature that focuses on certain corporate governance mechanisms and adds all other items that included in the most comprehensive list of recommendations of the codes (Huang, Shen, Shieh, & Tzeng, 2019). Our approach also benefits from data whose consistency has been reviewed by the stock market supervisor. During 2010-2017, the Good Governance Code had contained recommendations that can be classified in three categories according to their nature: (1) Board, bylaws & General Shareholder Meetings; (2) Directors and (3) Committees. The first category includes generic recommendations regarding the board of directors -size, composition, dedication, meeting frequency, attendance, information and advice, roles of the chairman and secretary, board evaluation- and regarding the general shareholder meeting and firm's bylaws. The second category deals with directors' selection, resignation and compensation and the third one comprises recommendations regarding audit, appointments and remunerations committees. During this period the Code has been amended twice, although these amendments do not respond to a significant change of approach in corporate governance -they are basically due to the gradual inclusion of some recommendations into mercantile law over time-. Nevertheless, we adjust for these amendments by constructing a corporate governance index for each category: -Board, bylaws & GSM; Directors and Committees- at the beginning of the period and identifying the correspondent recommendations in each of the subsequent codes, so that homogenous indexes can be used throughout the period. To this end we have disregarded those recommendations that disappear in later codes, -17 recommendations were removed from codes because they were transferred to law- and 23 recommendations that were added in the 2015 Code and lack a correspondent recommendation in the previous indexes. Table 9 describes the recommendations included in each category across the three codes.

We have checked the *prima facie* adequacy of the categories chosen -Board, bylaws & GSM; Directors and Committees- with an expert on corporate governance and we will leverage on factor analysis to select and weight the recommendations included in these categories, so that we arrive at reliable indexes.

The extant literature uses equally-weighted indexes Aggarwal et al. (2009); Chung & Zhang, (2011); Holm & Schøler (2010) that are forms with the simple addition of categorical variables. This approach assigns the same importance to recommendations widely discussed in the literature -i.e. reaching an adequate proportion of independent directors in the board – than to other recommendations which could be considered less important in relative terms -i.e. extent of information regarding directors' bios at the webpage-. The relevance of each of these recommendations can vary as can be observed in the annual corporate governance reports submitted to CNMV. For example, during 2010, only one firm out of the 153 public companies, did not follow recommendation number 16 -Chairman's responsibilities- while 45 firms did not follow recommendation number 12 -proportion between proprietary and independent directors-

Table 9: Corporate Governance recommendation and weights

	2010 Code (2010-2012)		2013 Code (2013-2014)		2015 Code (2015-2017)	Weight
	Board, bylaws and GSM					
10	Executive directors as few as possible	10	Executive directors as few as possible	15	Executive directors as few as possible	0,09855
12	Proportion between proprietary and independent directors	11	Proportion between proprietary and independent directors	16	Proportion of proprietary directors no greater than the % of capital they represent	0,1079
14	Disclosure on nature of directors at GSM	13	Disclosure on nature of directors	19	Disclosure for appointing proprietary directors that represent less han 3%	0,14094
16	Chairman's responsibilities	15	Chairman's responsibilities	33	Chairman's responsibilities	0,23539
18	Secretary of the board responsibilities	17	Secretary of the board responsibilities	35	Secretary of the board responsibilities	0,25621
19	Board of Directors frequency meetings	18	Board of Directors frequency meetings	26	Board of Directors frequency meetings (min. 8/year)	0,04319
22	Board annual evaluation	21	Board annual evaluation	36	Board annual evaluation	0,14252
24	Directors advice	23	Directors advice	29	Directors advice	0,12312
25	Directors training	24	Directors training	30	Directors training	0,08048
26	Directors dedication	25	Directors dedication	25	Directors dedication	0,16143
	Directors					
28	Directors bios at the webpage	27	Directors bios at the webpage	18	Directors bios at webpage	0,0993
30	Proprietary directors resignation	28	Proprietary directors resignation	20	Proprietary directors resignation when shareholders they represent decrease stake	0,21734
32	Rules on directors resignation following legal actions against them	30	Rules on directors resignation following legal actions against them	22	Rules on directors resignation following legal actions against them	0,15722
33	Directors opposing and eventually resigning because of proposals that might damage the corporate interest	31	Directors opposing and eventually resigning because of proposals that might damage the corporate interest	23	Directors opposing and eventually resigning because of proposals that might damage the corporate interest	0,17916
36	Variable compensation only for executives	33	Variable compensation only for executives	57	Variable compensation only for executives	0,26942
37	Directors compensation levels	34	Directors compensation levels	56	Directors compensation	0,27719
38	Remuneration linked to company earnings should bear in mind any qualificationsby auditor	35	Remuneration linked to company earnings should bear in mind any qualificationsby auditor	60	Remuneration linked to company earnings should bear in mind any qualificationsby auditor	0,08609
	Committees					
45	Internal Code od Conduct reporting to committees	40	Internal Code od Conduct reporting to committees	53	Compliance & CSR at audit/nomination/ad hoc committee	0,20093
48	Internal Audit annual reporting to Audit Committee	43	Internal Audit annual reporting to Audit Committee	41	Internal Audit annual reporting to Audit Committee	0,34992
49	Risk control and management policy	44	Risk control and management policy	45	Risk control and management policy	0,18728
50	Audit Commite functions	45	Audit Commite functions	42	Audit Commite functions	0,25575
51	Audit Committee empowered to meet with any employee	46	Audit Committee empowered to meet with any employee	43	Audit Committee empowered to meet with any employee	0,16254
58	Remuneration committee consulting with Chairman and CEO	53	Remuneration committee consulting with Chairman and CEO	51	Remuneration committee consulting with Chairman and CEO	0,10106

As a consequence, we have used factor analysis to create reliable and unidimensional corporate governance indexes -in terms of Cronbach's alpha and factors eigenvalues- and to assign weights -factor loadings- to each of the recommendations. We have traced comparable recommendations along the period of analysis and, out of the initial 58 recommendations, we have identified 41 that can be considered in force throughout the period of analysis -a category just changes its number or experiments minor adjustments to its wording-. We have then chosen 23 recommendations with the criteria of forming reliable and unidimensional indexes -the polychoric procedure used for multivariate exploratory analysis of ordinal data excludes items with very low variability (Angeles & Kolenikov, 2004)-. The factor analysis allows us to assign individual weights -see table 10- to each of the corporate governance recommendations included in the categories Board, bylaws & GSM -10 recommendations-, Directors -7 recommendations- and Committees -6 recommendations-.

Table 10 Factor analysis for each of the Corporate Governance Indexes

Varimax rotation	*Board, bylaws & GSM*	*Directors*	*Committees*
Factor 1 Eigenvalue	4.0902	3.00931	4.41487
Factor 2 Eigenvalue	0.89813	0.78853	0.95636
Cronbach's alpha	0.7129	*0.6586*	*0.7734*

In this way we calculate a score for every company, for each of the three corporate governance indexes and for each of the 8 years, enabling us to measure the state of corporate governance at the precise years when foreign investors participate in initial public offerings and capital increases

Moderating variables

First, our model tests the moderating effect of the *board international diversity* on the relationship between corporate governance code adoption and foreign capital attraction. Although the Spanish code recommends a "diversity of knowledge, experience and gender" CNMV (2015):23) no mention is made to diversity in terms of nationality. We have argued that the proportion of board members that come from a country different to the nation where firm is headquartered is related to the firm's capacity to gain foreign investors' confidence, so we need an extra variable to test this relationship. We will compute the proportion of foreign directors as percentage of total number of directors in line with (Du, Jian, & Lai, 2017; Oxelheim & Randøy, 2003).

The model also tests a second moderating effect: that of the presence of a controlling shareholder has on the effectiveness of corporate governance code adoption in terms of foreign capital attraction. We identify "*controlling shareholder*" as those holding at least 20% of capital, in line with La-Porta et al. (1999) and Faccio & Lang (2002). We hypnotized that the presence of a controlling shareholder may be a deterrent for foreign investors, unless there is other relevant shareholder and both monitor each other (Pagano & Roell, 1998). Following the criteria set up in La-Porta et al. (1999), we consider 10% as sufficient for monitoring the *controlling shareholder*. We have gathered data for the identification of "controlling shareholders" (+20%) and "monitors of controlling shareholders" (+10%) from the filings that all shareholders with more than 3% of a Spanish listed company must disclose.

Control variables

The analysis of foreign capital attraction must take into account the *liquidity of the shares* -investors prefer liquid shares that can be bought and sold with less impact on prices Bushee et al. (2014); Chung & Zhang (2011); Kim et al. (2011)-; *firm size* -with smaller companies being perceived as riskier Aggarwal et al. (2011); Bushee et al. (2014); Holm & Schøler (2010); Miletkov et al. (2014); Oxelheim & Randøy (2003)-; equity value/ book value -investment in firms with high market to book ratios are riskier Aggarwal et al. (2011); Bushee et al. (2014); Ferreira & Matos (2008); Hadani, Goranova, & Khan (2011); Kim et al. (2011)-; return on assets -firms with higher profitability levels are preferred Aggarwal et al. (2011); Chung & Zhang (2011); Lo, Wu, & Kweh (2017); Neupane & Neupane (2017)-; and leverage -highly leveraged firms are perceived as riskier- (Aggarwal et al., 2011; Chung & Zhang, 2011; Ferreira & Matos, 2008; Hadani et al., 2011; Miletkov et al., 2014)-.

Two additional controls are considered. We control for *degree of firm's internationalization* (Filatotchev, Poulsen, & Bell, 2018). Internationalization has been characterized in the literature by the extent of international experience, measured with the track record of foreign sales in terms of number of years exporting Stoian & Rialp (2011) and the geographical diversity of international sales, measured with the number of foreign markets served (Brouthers & Nakos, 2005). Sullivan (1994) proposed five measures -foreign sales as a percentage of total sales, foreign assets as a percentage of total assets, overseas subsidiaries as a percentage of total subsidiaries, psychic dispersion of international operations and top managers' international experience- and we will use foreign sales as a percentage of total sales given the homogenous measure that it provides to compare internationalization across companies -i.e. while only some companies report on foreign assets or top managers' international experience, all of them report foreign sales- . This ratio is also the most common measure (Aitken, Hanson, & Harrison, 1997; Bernard & Jensen, 2004; Chevassus-Lozza & Galliano, 2003).

Lastly, it must be considered that most of the companies in the sample conduct several transactions. We have controlled by this fact by creating a dummy variable that equals cero during the first three transactions and one from the forth transaction onwards, since only 25% of firms conduct more than 3 transactions. Firms attempting to raise funds in the market an anomalous high number of times are more likely trying to replenish equity after losses rather than financing growth, therefore facing increasing difficulty in attracting foreign capital.

Table 11: Descriptive statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
Foreign participates	401	0.7257	0.4467	0.0000	1.0000
Board&others	401	0.8657	0.1388	0.2133	1.0000
Directors	401	0.8655	0.1573	0.1357	1.0000
Committees	401	0.8924	0.1784	0.0000	1.0000
Eqweigh_Index	401	0.9110	0.0665	0.5375	1.0000
Firm size	401	1560839	5127230	6576	50900000
Market-book	401	1.6549	13.5982	-63.6284	188.2568
ROA	401	-0.6127	3.3758	-30.5664	4.8593
Leverage	401	0.3755	0.2152	0.0000	0.9209
Liquidity	401	1.6640	1.5716	0.0000	7.2560
First transactions	401	0.6234	0.4851	0.0000	1.0000
Foreign sales	401	0.4250	0.3425	0.0000	0.9599
Controlling Shareholder	401	0.3117	0.4638	0.0000	1.0000
Foreign Directors	401	0.1358	0.1677	0.0000	0.6667

Foreign participates: Dummy, foreign investors participate=1, **Board, Directors and Committees**: Indexes constructed as described in section 4, **Eqweigh Index**: Index averaging all corporate governance recommendations**, Firm Size**: Market capitalization, in thousands €, **Market-book**: Market capitalization / book value, **ROA**: Net income / total assets, **Leverage**: Long term liabilities / total assets, **Liquidity**: Share turnover value / market capitalization, **First transactions**: Dummy =0 during the 3 first transactions, **Foreign sales**: Percentage of revenues coming from abroad, **Controlling shareholder**: Dummy =1 if a controlling shareholder is present, **Foreign directors**: Percentage of foreign directors at the firm's board

Table 12: Correlation matrix

	Foreign participates	Board &others	Committees	Directors	Foreign directors	Controlling shareholder	Foreign sales	Firm size	Leverage	Liquidity	Market-book	ROA	First transactions
Foreign participates	1												
Board&others	0.078	1											
Committees	0.1705*	0.2476*	1										
Directors	-0.0339	0.1804*	-0.0392	1									
Foreign directors	0.0825	-0.0167	0.1820*	-0.1189*	1								
Controlling shareholde	0.0518	-0.0976	0.2609*	-0.2845*	0.1903*	1							
Foreign sales	0.0011	0.1191*	0.1327*	0.2665* -	0.0888	-0.1146*	1						
Firm size	0.0788	0.0654	0.1273*	0.1542*	0.1623*	-0.023	0.1470*	1					
Leverage	0.0903	0.0033	0.2565*	-0.2159*	0.1572*	0.0078	0.3031*	0.1031*	1				
Liquidity	-0.0154	0.0279	-0.071	-0.1537*	-0.2172*	-0.0218	0.1636*	-0.0646	-0.1711*	1			
Market-book	0.0014	-0.1193*	0.0871	0.0756	0.0153	-0.1364*	0.0268	0.0158	0.1486*	0.0027	1		
ROA	0.1079*	-0.0343	0.0305	-0.0904	0.1019*	0.1246*	0.0644	0.0768	0.0913	0.0524	0.0046	1	
First transactions	-0.1087*	0.0998*	0.0073	-0.2275*	-0.0365	0.1008*	0.1057*	-0.2002*	0.1797*	0.2523*	-0.0765	0.1628*	1

3.5 Results

Since we are testing whether foreign investors participate capital market transaction, and our dependent variable is binary, we are using logit repressions for our analysis. We compare the results of four models fitted with logit regressions in table 13. The first model includes only control variables (column #1). The second and third models (columns #2 and #3) build on the first one by adding the 3 corporate governance indexes that we have constructed using factor analysis, with fixed year effects in the case of the third model. The inclusion of fixed year effects significantly increases the explanatory power of the second model -Pseudo R2 of 0.1067 versus 0.0594-. The forth model is a robustness check for our measure of corporate governance through the indexes constructed (column #4). We use an alternative index -the equally-weighted index- by calculating the arithmetic mean of the values for the 41 recommendations that the three Corporate Governance Codes in force during the period of analysis have in common. Among control variables, the dummy variable "first transactions" indicates whether the transaction is among the 3 first in the period of analysis. It is significant at the 1% level and shows how firms gradually exhaust their capacity to attract foreign capital: from the forth transaction onwards, the probability of attracting foreign capital significantly decreases, which is the case of 25% of firms in the sample. Firms attempting to raise funds in the market more than three times are more likely trying to replenish equity after losses rather than financing growth, therefore facing increasing difficulty in attracting foreign capital -this is certainly the case of one of the firms which tapped the capital market 72 times during the eight years -. We also observe that return on assets is significant at the 5% level and its odd-ratio indicates that, as expected, higher profitability increases the probability of attracting foreign investors. It is interesting that the control variable foreign sales is not significant. Although as noted in Sanders (1998) internationalization compounds the agency problem, making corporate governance more relevant for foreign investors, due to increased information asymmetry between owners and managers with privileged access to dispersed information across countries, it may be the case that foreign investors are less reluctant to participate in transactions of companies that are well known through their foreign sales -and corporate governance less relevant in the transactions performed by well know firms-In the second model, only the *Committees* index is significant and indicates that a higher compliance with the *Committees* recommendations is associated to a higher probability of attracting foreign capital. Foreign investors particularly value -in order of importance- the recommendations regarding the internal audit unit reporting to the audit committee, functions of the audit committee, internal codes of conduct, risk control and management policy, the empowerment of the audit committee to talk to any employee and the functioning of the remuneration committee (Fairchild, Gwilliam, & Marnet, 2019; Park, 2019; Pérez-Cornejo, Quevedo-Puente, & Delgado-García, 2019). Once fixed year effects are taken into account, both *Board, bylaws and GSM* and *Committees* are significant at the 5% level and cause higher probability of foreign capital taking part in the transactions, in line with hypothesis 1. Therefore, together with the *Committees* recommendations, the following ones also become appreciated by foreign investors -in order of importance-: secretary of the board responsibilities, chairman responsibilities, directors dedication, board annual evaluation, disclosure for appointing proprietary directors that represent less than 3% of capital, directors advice, proportion of proprietary directors no greater than the percentage of capital represented, executive directors as few as possible, directors training and board frequency meetings. The odds ratios of *Board, bylaws and GSM* (7.581) and *Committees (5.099)* indicate that foreign investors assign a relatively bigger importance to the *Board* group of recommendations. It is well worth mentioning that we included fixed year effects for every year except one to avoid multicollinearity among them. We did not include the worst year in terms of financial crisis -2012, since the Spanish government requested financial assistance on June 2012- and, as expected, all significant fixed year effects for the remaining years are positive. The equally-weighted index is significant at the 10% level, versus the indexes *Board, bylaws and GSM* and *Committees* that are significant at the 5%. Additionally, the *Board, bylaws and GSM* and *Committees* comprise 10 and 6 recommendations respectively, versus the equally-weighted index that includes 41 recommendations. *Board, bylaws and GSM* and *Committees* allow firms to focus on a reduced number of recommendations to attract capital, also being able to discriminate in advance, according to their weights, the predicted impact of the recommendations contained in *both indexes* on foreign capital attraction. We analyze the impact of *Foreign Directors* as a moderating variable in columns #5, #6 and #7 of Table 13 The percentage of members of the board that are foreigners interacts significantly with the index *Committees* (column #7). *Foreign Directors* is significant at the 1% level and drastically increases the probability of attracting foreign capital. Compliance with the recommendations of the *Committees* index is also significant at the 1% level and attracts foreign capital. Lastly, we examine the impact of *Controlling Shareholder* as a moderating variable in columns #8, #9 and #10 of Table 13. The presence of a controlling shareholder drastically decreases the probability of attracting foreign capital -at the 1% significance level- and interacts significantly with the index *Directors (column #9),* indicating that those transactions performed by firms with a controlling shareholder and a high degree of compliance with the *Directors* index, are more likely to obtain foreign capital at the 1% level.

Table 13: Impact of corporate governance indexes on foreign capital attraction

	Controls	CG Indexes	CG Indexes YFE	Eqweight Index YFE	Foreign directors moderating Board&o.	Foreign directors moderating Directors	Foreign directors moderating Committees	Controlling shareholder moderating Board&o.	Controlling shareholder moderating Directors	Controlling shareholder moderating Committees
Firm size	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000
	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)
Market-book	0.995	0.995	0.992	0.989	0.991	0.99	0.966**	0.992	0.993	0.991
	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)
ROA	1.075**	1.080***	1.122***	1.124***	1.119***	1.117***	1.098**	1.121***	1.109**	1.120***
	(0.03)	(0.03)	(0.05)	(0.05)	(0.05)	(0.05)	(0.05)	(0.05)	(0.05)	(0.05)
Leverage	4.097**	2.763	2.586	6.844***	2.39	2.288	4.753*	2.714	2.732	2.688
	(2.5)	(1.89)	(2.04)	(4.81)	(1.9)	(1.82)	(3.96)	(2.15)	(2.28)	(2.11)
Liquidity	1.086	1.098	1.043	1.067	1.05	1.062	1.039	1.039	1.015	1.028
	(0.08)	(0.09)	(0.1)	(0.09)	(0.1)	(0.1)	(0.1)	(0.09)	(0.09)	(0.10)
First transactions	0.465***	0.430***	0.496**	0.516**	0.504**	0.512**	0.594*	0.498**	0.598*	0.487**
	(0.12)	(0.12)	(0.15)	(0.15)	(0.15)	(0.15)	(0.19)	(0.15)	(0.18)	(0.15)
Foreign sales	0.723	0.696	0.75	0.499	0.771	0.728	0.706	0.768	0.669	0.795
	(0.28)	(0.3)	(0.37)	(0.22)	(0.37)	(0.36)	(0.37)	(0.38)	(0.32)	(0.39)
fe2010			7.244**	5.878**	7.406**	5.214**	5.488**	8.277***	5.699**	8.648***
			(5.82)	(4.54)	(5.91)	(4.28)	(4.49)	(6.7)	(4.78)	(6.98)
fe2011			2.318	1.773	2.395	1.943	2.798*	2.488*	2.503*	2.545*
			(1.23)	(0.91)	(1.28)	(1.06)	(1.57)	(1.34)	(1.33)	(1.37)
fe2013			2.188	1.529	2.250*	1.735	2.114	2.248	1.812	2.279*
			(1.06)	(0.70)	(1.1)	(0.91)	(1.08)	(1.11)	(0.92)	(1.13)
fe2014			2.700**	2.048	2.857**	2.209	2.046	2.999**	2.173	3.264**
			(1.34)	(0.97)	(1.43)	(1.19)	(1.07)	(1.56)	(1.19)	(1.71)
fe2015			6.778***	3.503**	7.368***	4.998**	6.202***	7.450***	3.845**	7.898***
			(3.9)	(1.89)	(4.31)	(3.14)	(3.97)	(4.3)	(2.35)	(4.6)
fe2016			7.725***	4.723***	7.901***	5.598***	7.569***	7.910***	5.918***	9.679***
			(4.49)	(2.77)	(4.61)	(3.5)	(4.72)	(4.63)	(3.59)	(6.09)
fe2017			4.155**	2.908*	4.276***	2.840*	4.068**	4.707***	3.241*	5.074***
			(2.3)	(1.6)	(2.37)	(1.79)	(2.29)	(2.82)	(1.99)	(3.07)
Board & others		3.153	7.581**		9.704**	8.239**	2.729	8.743*	6.898*	7.037*
		(2.59)	(7.34)		(10.77)	(8.24)	(2.81)	(9.97)	(6.99)	(7.16)
Directors		0.700	0.313		0.322	0.081	0.74	0.396	0.038**	0.417
		(0.66)	(0.34)		(0.35)	(0.13)	(0.82)	(0.43)	(0.06)	(0.45)
Committees		4.924**	5.099**		4.691**	5.591**	43.593***	3.895*	5.693**	3.017
		(3.12)	(3.5)		(3.17)	(3.78)	(34.52)	(2.94)	(4.16)	(2.39)
Eqweight Index				62.376*						
				(141.98)						
Foreign directors					14.543	0.000	1.930e+24***			
					(57.04)	(0.00)	(3.23E+25)			
Board&o. # Foreign Dir.					0.074					
					(0.34)					
Directors # Foreign Dir.						18344.593				
						(139899.6)				
Committees # Foreign Dir.							0.000***			
							(0.00)			
Controlling shareholder								1.326	0.006***	0.183
								(2.18)	(0.01)	(0.33)
Board&o. # Controlling shareholder								1.022		
								(1.97)		
Directors # Controlling shareholder									574.810***	
									(1227.05)	
Committees # Controlling shareholder										8.358
										(15.71)
Constant	2.646***	0.408	0.118	0.027*	0.091*	0.446	0.017***	0.089	0.900	0.123
	(0.85)	(0.46)	(0.17)	(0.05)	(0.13)	(0.86)	(0.02)	(0.14)	(1.53)	(0.18)
Pseudo R2	0.0382	0.0594	0.1067	0.0861	0.1078	0.1114	0.1684	0.1085	0.1283	0.1103
Number of obs	401	401	401	401	401	401	401	401	401	401

Standard errors in parentheses using robust standard errors to adjust for heteroskedasticity
The symbols *, **, *** denotate significance at the 10%, 5% and 1% levels, respectively

3.6 Discussion

Overall, we have seen that firms that follow corporate governance recommendations increase their probability of attracting foreign capital, as stated in hypothesis 1. This positive effect of corporate governance code adoption is in line with the results obtained by Goncharov et al. (2006), although these authors found the benefits in terms of corporate valuation, rather than foreign capital attraction.

Our data show a significant relationship for corporate governance recommendations related with Board, bylaws & General Shareholder Meeting and Committees, but not for those recommendations related to Directors' selection, resignation and compensation. While some of these recommendations may not be monitored by investors because of being followed by most firms -information on directors' cvs on the corporate web- or because of being too detailed– the setup of rules on directors' resignation following legal actions against them-, it is not obvious why recommendations on compensation are not significant in terms of foreign capital attraction. A plausible explanation may be found in the extensive compulsory legislation on directors' compensation that reduces the relevance of voluntary corporate governance. Codes of good governance have been found to be complements to national laws and regulations Aguilera & Cuervo-Cazurra (2009) and since Spain has implemented a detailed regulation regarding directors' remuneration reporting in the last years (Sustainable Economy Act 2/2011, Order ECC/461/2013, CNMV Circulars 4/2013 and 7/2015), this matter may be less of a concern for foreign investors after compulsory law have been enacted. Additionally, compensation of Spanish executives has not been at the front of controversy, in contrast with other countries.

Regarding hypothesis 2, we find that following Committees recommendations strongly increases the likelihood of attracting foreign capital, that a high proportion of *Foreign Directors* drastically increases the probability of attracting foreign capital, in line with the beneficial effects predicted by Oxelheim & Randøy (2003) and a significant interaction of *Foreign Directors* and the corporate recommendations dealing with *Committees.* This interaction's odd-value close to zero points to the fact that firms choose between these two corporate governance mechanisms alternatively. Therefore, a high proportion of foreign directors poses such a strong incentive for foreign investors that, rather than reinforcing the effect of corporate governance on foreign capital attraction, firms with those high number of foreign directors do not invest in compliance with the *Committees* index. On the other hand*,* a low proportion of foreign directors is compensated by firms with a high level of compliance with the *Committees index.*

Regarding hypothesis 3, we have found that the presence of a *controlling shareholder* drastically decrease the probability of attracting foreign capital, in line with the adverse effects described by Pagano & Roell (1998); Young et al. (2008) but the effect of a controlling shareholder on corporate governance recommendations is not significant with the exception of those recommendations related to Directors: those transactions performed by firms with a controlling shareholder and a high degree of compliance with the *Directors* index, are more likely to obtain foreign capital. This result is challenging because we had not found compliance with the recommendations of the *Directors* index significant prior to considering the presence of controlling shareholders. A plausible explanation lies in the fact that the presence of a controlling shareholder is such a strong deterrent for foreign investors that compliance with Directors -which otherwise is not valued by foreign investors- becomes a necessary complement to gain the confidence of foreign investors.

3.7 Conclusion

In a similar way that exposure to foreign investment has been found connected to codes diffusion at the country level Aguilera & Cuervo-Cazurra (2009), we have found evidence of a positive relationship between the degree of code adoption at the firm level and the volume of foreign funds attracted by the firm. We have identified a reduced set of corporate governance recommendations that foster foreign investors to overcome these obstacles and provide financing to Spanish firms conducting capital increases and IPOs. Out of the 64 recommendations contained in the Spanish Good Governance Code, 10 recommendations dealing with the board of directors, bylaws and general shareholder meeting; and 6 recommendations dealing with the committees of the board are found to be relevant and positive for attracting foreign capital. When a controlling shareholder is present at the firm, another 7 recommendations become relevant and positive to attract foreign capital.

Foreign directors contribute to reduce information asymmetries associated with cultural and linguistic differences, are more independent from the firm than local investors, use their superior monitoring skills to control management, and provide higher advisory capabilities that can contribute to increase the level of confidence of foreign investors. We have found that the presence of a high proportion of foreign directors is a strong incentive for foreign investors to participate in capital market transactions and firms use as alternative corporate governance mechanisms a high proportion of foreign directors and compliance with *Committees* recommendations

Our research suffers from the limitation of considering only transactions conducted in Spain. Investors may regard corporate governance mechanism differently when assessing transaction undertaken in countries with different legal systems. We have not discriminated for foreign investors' country of origin: it would be interesting to analyze if their preferences of corporate governance recommendations vary according to their home countries. Lastly nationality of foreign directors has not been discriminated either, which poses an additional limitation. Foreign directors superior monitoring skills and higher advisory capabilities may be restricted to those countries whose capital markets are more developed.

Future research could explore which corporate governance recommendations are implemented by firms depending on institutional factors related to directors, such as their nationality, education or professional background. Additionally, it would be valuable to construct corporate governance indexes similar to the 3 presented in this work for a common law country, characterized by stronger investor protection and dispersed ownership structures. Also, since the adoption of corporate channels may decrease information asymmetries and increase the likelihood of foreign capital attraction, future research could explore the channels through which these reduction of information asymmetries takes place.

Spanish firms pursuing foreign capital may use the weighted indexes presented to focus their efforts on a reduced number of recommendations, rather than the large number contained in the Code of Good Governance. Firms may draw on cost-benefit analysis to decide on the implementation of different recommendations taking into account that the index *Board* has a higher impact than *Committee and* discriminating recommendations according to their weight in each index.

Lastly, the weighted indexes have implication for the design of corporate governance codes by stock market supervisors and group of experts that participate in their drafting. The *comply or explain* principle lead codes to list all recommendations without assigning any relative importance to them, which implies a burden on investors. Although is up to investors to judge each of the explanations that firms provide when they decide not to follow a recommendation, and up to investors to decide which recommendations are more important for them, regulators could signal somehow the importance that *prima facie* recommendations present.

Chapter 4. The impact of the institutional framework on board composition

4.1 Introduction

Corporate governance has been defined as the "ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" (Shleifer & Vishny, 1997). These "suppliers of finance" aiming at a return can be classified into minority and controlling shareholders, being the latter able to significantly influence or even to control the company. Minority shareholders are particularly vulnerable: they make sunken investments, and both managers and controlling shareholders might extract rents from the firm in detriment of minority shareholders (Lozano, Martínez, & Pindado, 2016).

As predicted by the agency theory, the separation of ownership and control may lead to managers or "agents" behaving opportunistically in detriment of minority shareholders or "principals" (Fama & Jensen, 1983a; Jensen & Meckling, 1976). Managers may divert corporate assets by selling assets to themselves at favorable prices, by above market salaries, stock options or through outright theft. This rent extraction is called "tunneling" (Johnson et al., 2000). Managers may also follow corporate strategies that yield them personal benefits of control, such as growth or diversification -"empire building"- at the expense of shareholders' interest; resist to value-increasing takeovers or simply manage inefficiently (La-Porta et al., 2000a). Additionally, the "tunneling" or transferring of funds out of the firm may be done not by managers, but by a controlling shareholder. In this case, instead of the traditional "principal-agent" conflict, there is a "principal-principal" conflict between controlling and minority shareholders (Young et al., 2008). This abuse can be performed by direct ownership or by control enhancing mechanisms designed to achieve high control rights without the equivalent proportion of ownership, such as the use of pyramids and dual class shares - shares with differential voting rights- (Claessens et al., 2002).

The composition of the board of directors is at the center of corporate governance (Dalton et al., 1998). Members of the board of directors are either executive directors - "insiders" of the firm that belong to the top management team- or outside directors. Non-executives or "outsiders" are heterogenous in nature: they may be independent from the firm – "outside-independent directors"- or represent a relevant shareholder – "outside-proprietary directors". Independent and proprietary directors are particularly well suited to act as a counterbalance to the power that the CEO accumulates and allow for efficient monitoring of its performance (Pearce & Zahra, 1992).

More than twenty years after Jensen & Meckling (1976) highlighted the relevance of board composition, abundant studies have focused on, first, the impact that outside directors have on firm performance and, later, on the specific relevance of the chairman of the board being an outside director, rather than an insider, as is the case of dual CEOs who also chair the board of directors. A majority of outside directors confers the board with both independence from the company and capacity to monitor and control its management. But board independence does not seem consistently linked to firm performance (Dalton et al., 1998). Why do most corporate governance codes advocate for it? Are all kind of outside directors effective under different institutional frameworks?

Abundant research has leveraged on the agency theory to study the monitoring role of the firm's main governance body, the board of directors. The extant literature has focused on the contribution of outside directors, less biased and theoretically better prepared to judge manager's performance and protect shareholders (Fama, 1980; Hillman et al., 2000; Jakpar, Tinggi, Kah, Khin, & Myint, 2019; Mizruchi, 2004; Pearce & Zahra, 1989; Weisbach, 1988). But outside directors are heterogeneous in nature: they may be independent from the CEO or not, by, for instance, having personal or business relations with the firm or represent a relevant investor. To gain a better understanding between the presence of outside directors in the board and firm performance, this paper will try to contribute by breaking up the outside director category and focusing on the two different kinds that may influence firm performance significantly: outside-independent directors and outside-proprietary directors. Outside-independent directors' capacity to control managers have concentrated a significant part of the literature, but scant attention has been devoted to the role of those directors that represent shareholders with a significant stake: the proprietary directors (Acero & Alcalde, 2014; Garcia-Sanchez, Cuadrado-Ballesteros, & Sepulveda, 2014). Proprietary directors do not only monitor managers, but also provide useful advisory and access to outside resources (Pfeffer & Salancik, 1978). This paper will contribute by comparing the contribution of boards with a prevalence of outside-proprietary directors with that of outside-independent directors.

Besides the heterogeneous nature of outside directors, the existence of different institutional frameworks may also contribute to explain the lack of conclusive findings between board composition and firm performance. The impact of the legal system on investor protection has given rise to a whole wave of research on corporate governance. Laws and their enforcement are key in investor protection, and examples of this protection are the right to receive the same per share dividends, to the right to vote on important corporate matters, such as the election of directors or the right to sue the company for damages (La-Porta et al., 2000a). Until the mid-1990s most research on corporate governance was focused on the United States but since then a growing interest is being developed on international comparisons, based on each country legal system –laws and enforcement systems-. The last generation of corporate governance literature has focused on the influence of a particular country's legal system on investors protection (Djankov et al., 2008; Hail & Leuz, 2006; Jackson & Roe, 2009; La-Porta et al., 2006). There is an increasing need for research around the institutional factor of corporate governance. As pointed out by Aguilera & Jackson (2003):449), "despite a growing consensus that institutions matter, comparative institutional analysis remains in its infancy. Comparing and explaining cross-national diversity require systematic specification of what institutions matter and how they shape corporate governance". We will address the following research question: what kind of outside directors are more effective in terms of firm performance for different institutional frameworks?

With this objective, this paper integrates the approach of corporate governance studies that focus on the effectiveness of governance mechanisms used by firms at one country Bhagat & Black (2001); Dahya, Mcconnell, & Travlos (2002); Holderness (2003); Huson, Parrino, & Starks (2001), with the approach of studies that explore the impact of the legal system on corporate governance at the country level (Djankov et al., 2008; La-Porta et al., 2006; La-Porta, Lopez-de-SIlanes, Shleifer, & Vishny, 2002; Mintz, 2005). We investigate the impact of different institutional frameworks at seven countries on the effectiveness of board composition, finding statistical significance for the relationship between the proportion of strongly independent directors and firm valuation: this relationship is found to be positive in common law countries. We also take into consideration the impact of ownership structure, namely the extent to which the power of the largest shareholder is contested by the second and third largest shareholders, to revisit the effectiveness of board composition. We find that in civil law countries, where ownership concentration allows relevant shareholders to have board representation, the positive effect of proprietary directors does not compensate for the negative effect of several proprietary directors representing a powerful largest shareholder, who may abuse his position in detriment to minority investors. But in civil law countries, the joint presence of proprietary directors and a "controlling coalition" that limits the power of the largest shareholder has a positive impact on valuation.

4.2 Management control, resource provision and different outside directors

The board works as a link between firm management and owners. While the CEO and the top management team are in charge with executing the company strategy and managing the business, the board of directors defines the company strategy, controls its execution and assists the management by contributing their industry and functional expertise, networking, legitimacy, and access to suppliers, public policy decision makers and social groups, therefore increasing survival likelihood (Gales & Kesner, 1994; Singh et al., 1986).

In order to assess the effectiveness of a board composition, it is necessary to consider both its control and resource provision roles, building on the work by (Hillman & Dalziel, 2003). While agency theory emphasizes the role of incentives to ensure that the board monitors and controls managers Fama & Jensen (1983b), resource dependence theory Pfeffer & Salancik (1978) emphasizes the role of board capital –both human and relational capital- to provide resources such as advice, legitimacy, communication with external organizations and preferential access to outside resources (Tuggle et al., 2010).

These two roles of the board of directors, management control and resource provision, are interrelated. Resource provision depends on board capital, that is, the human and relational capital provided by its directors: skills, network, expertise and knowledge. But board capital affects not only the provision of resources, but also management control: if the board does not have the necessary skills, it will be unable to effectively evaluate and control management. Management control is facilitated by board independence, but board independence is not so helpful for the provision of resources: directors with personal or professional ties with the firm are likely to be very active providing advice and counsel (Haynes & Hillman, 2010; Hillman et al., 2000; Lynall et al., 2003).

Members of the board of directors are either executive directors - “insiders” of the firm that belong to the top management team- or outside directors. “Outsiders” are non-executives directors that may be independent from the firm and its shareholders – “outside-independent directors”- or independent from the firm but represent a relevant shareholder – “outside-proprietary directors”. It is well worth clarifying terminology in this regard: extant literature has devoted so far scant attention to outside-proprietary directors and when the term “independent director” is used, it refers to outside-independent directors, in spite of both kind of outside directors being independent from the firm.

4.2.1 Management control and independent directors

Dealing with the role that outside directors play, different studies have shown the contribution of outside directors to management control, focusing on their independence from the management team. When managers divert corporate assets, use them to pursue investment strategies that yield them personal benefits of control at the expense of shareholders’ interest or are simply not efficient, outside directors will replace them to improve performance. Outside directors are less biased and theoretically better prepared to judge manager’s performance and protect shareholders (Fama, 1980; Mizruchi, 2004; Pearce & Zahra, 1989; Weisbach, 1988). Daily & Dalton (1994) analyzed the relationship between governance structure and corporate bankruptcy and found that bankrupt firms will have higher proportions of affiliated (non-independent) directors than survivor firms. Outside directors also play a fundamental role in mitigating the agency problem by requiring the firm to increase its level of transparency, therefore reduce information asymmetry and agency costs. Voluntary disclosure increases with the proportion of outside directors (Ajinkya, Bhojraj, & Sengupta, 2005; Donnelly & Mulcahy, 2008; Elshandidy & Neri, 2015; Gul & Leung, 2004). The need for independence to control the power of the management team has led not only to advocate for a majority of outside directors, but even to limit the CEO as the only insider at the board Joseph, Ocasio, & McDonnell (2014), to eliminate the CEO’s role as a board member entirely Wade et al. (1990) or to limit the tenure of the CEO (Kay & Silberstone, 1995).

Although some evidence support the contribution of outside directors to management control and firm performance and valuation, the existing literature is not conclusive (Dalton et al., 1998). The heterogeneous nature of outside directors may be behind this lack of evidence, as outside directors may have personal or business relationships with the firm – "outside-affiliated directors"-, may be independent from the firm – "outside-independent directors"- or represent a relevant shareholder – "outside-proprietary directors". To gain a better understanding between the presence of outside directors in the board and firm performance, rather than considering all kind of outside directors, a fine-grained analysis have contributed by analyzing in isolation two different kind of outside directors: those that are independent from the firm and its shareholders – "outside-independent directors"- and those that are independent from the firm but represent a relevant shareholder – "outside-proprietary directors".

Outside-independent directors, given the absence of ties with the management team, are well positioned to protect all minority investors, but the definition of independence is challenging, as it varies depending of the code of corporate governance of each country. While in the US independence is presumed for any director who is not an executive or shareholder with over 10% of capital, in Europe corporate governance codes include detailed and different characterizations of independence, sharing family ties and former employment relationships as disqualifying features for independence (Aguilera, 2005). Public criticism has been constant about the lack of genuinely independent directors at public companies and several studies have failed to prove a positive relationship between the presence of independent directors and firm performance and valuation (Tung, 2011). Ma & Khanna (2016) offered a different approach by directly showing the lack of real independence. Taking advantage of a peculiarity in the Chinese regulation –disclosure of dissent by directors is compulsory-, they tested the degree of directors' real independence and found that dissent is more likely to occur when the board chair who appointed the independent director has left the board, or when the board "game" is reaching its last round, defined as a 60-day window before chairman or director departure.

Setting up a minimum proportion of independent directors may be a corporate governance mechanism aimed at gaining legitimacy, but it is not clearly stated to which extent it responds to genuine will to protect shareholders or to what Meyer & Rowan (1977) called "myth and ceremony". A more stringent definition or "strong independence" can be obtained after making two adjustments to formal classifications of "independent" directors. Firstly, the independent director has necessarily joined the board prior to the CEO tenure, following the results of Coles, Daniel, & Naveen (2014), who found that board monitoring decreases with the fraction of the board comprised of directors appointed after the CEO assumed office. And secondly, the independent director cannot not serve in more than two additional boards. Although multiple directorships were initially considered a certification of a director's abilities Fama & Jensen (1983b), directors with multiple appointments have less time available to effectively control management, as shown by (Cashman, Gillan, & Jun, 2012). Actually CEOs have been found to prefer "independent" directors with multiple board directorships Shivdasani & Yermack (1999) and firms with a majority of outside directors serving in multiple boards have worse performance and are less likely to fire the CEO (Fich & Shivdasani, 2006).

Independent directors, given their lack of ties with the management team, may be capable of effectively controlling the firm, as long as their independence is real and can be exercised with enough dedication of time. We therefore propose the following hypothesis:

Hypothesis 1: *Firms with a higher proportion of strongly independent directors in their board obtain a higher stock market valuation*

4.2.2 Resource provision and "proprietary directors"

Besides the governance function of the board of directors –controlling managers and ensuring that corporate action is aligned with shareholders' interests-, the board also serve as a link with the external environment, contributing to resource provision, environmental scanning and opportunity seeking (Tuggle et al., 2010). In the resource dependence theory, several factors are a source of uncertainty and external dependencies that directors can help to mitigate –i.e. availability of capital, regulatory environment, new technologies, etc.- (Pfeffer & Salancik, 1978). Moreover, the access to valuable resources increases firm legitimacy by enhancing the reputation and credibility of their firms (Daily & Dalton, 1994; Daily & Schwenk, 1996; Hambrick & D'Aveni, 1992). This is for example the case when a family controls multiple firms: each firm of the informal business group gain access to the family resources and share the group's reputation capital. The controlling family works as a boundary spanner of the organization and its environment (Peng & Jiang, 2010b). Also firms showing high performance may be less concerned about management control, since a track record of high performance may be a good sign of alignment between shareholders and executives (Pfeffer & Salancik, 1978). These high performing companies may overweight the resource acquisition role of their Board of Directors, rather than management control.

The extant literature has examined the resource provision role of outside-directors. But scant attention has been devoted to the contribution of outside-proprietary directors in particular. One reason for this paradox may be of institutional nature. To the best of our knowledge, only the legal systems of Spain and Mexico include a mechanism that allow investors to directly appoint a number of directors proportional to their stake in the firm's capital. Actually directors appointed through this mechanism must be reported to the stock market supervisor as "consejeros dominicales", so that their link to the relevant shareholder is clearly signaled to all market participants. This is not the case in the rest of the world, although relevant investors obviously try to vote and get some directors elected according to their preferences in spite of the lack of a direct mechanism to appoint a number of directors proportional to their stake in the firm's capital. Across the world, some companies disclose the link between certain outside investors and relevant shareholders in their websites and annual reports, other do not. This may explain why the term “outside-proprietary” director is seldom used, and most of the literature has focused on outside-independent directors.

As the ownership stake of the investor increases, she has a greater incentive to increase firm value (Holderness, 2003). The significant amounts of funds necessary to get board representation are an incentive to commit resources, provide contacts and devote extensive time to assist the management team, given the size of the investment at risk made by the shareholder represented by the proprietary director. Theoretically, outside-independent directors can also contribute to resource acquisition with their expertise as long as they devote the requisite time and attention to the board. Outside-proprietary directors may have less outside boards and devote more time than outside-independent directors, who are chosen because of their skills, accomplishments, and connections, therefore most of them are extremely busy (Hambrick, Misangyi, & Park, 2015). Outside-proprietary directors have a string incentive to contribute to the board not only because their reputation is at risk, as in the case of independent-outside directors Garcia-Sanchez et al. (2014), but because of their linkage to relevant shareholders, who are risking their wealth. Large institutional investors such as pension funds, hedge funds and insurance companies are represented by proprietary directors typically have direct access to management and use their skills to closely monitor firm performance. Also, economies of scale due to the size of their investment render the cost of acquiring value-relevant information relatively lower. Proprietary directors can be instrumental for the information advantage of large institutional owners described by (Schnatterly, Shaw, & Jennings, 2008). And even institutional investors with smaller stakes in the firm –“blockholders”- hold a regular communication with management and try to influence it, but if their stake is big enough they would rather be directly involved in management supervision and advice through membership of the board of directors (Holderness, 2003).

The significant funds invested by the shareholders represented by outside-proprietary directors provide strong incentives for the effective contribution of these directors to resource acquisition and eventually also to management control. In contrast with the debate over the independence of directors classified as such, proprietary directors are clearly defined by its association with a relevant shareholder and we contend that their commitment with the firm will contribute to improve its performance and valuation. Based on that, we propose that:

Hypothesis 2: *Firms with a higher proportion of outside-proprietary directors in their board obtain a higher stock market valuation*

4.3 The impact of the institutional framework on the composition of board of directors

Both outside-independent and outside-proprietary directors can contribute to the board and therefore to firm's valuation. As we have discussed, the contribution of independent directors can be particularly significant in terms of management control Ajinkya et al. (2005); Donnelly & Mulcahy (2008); Elshandidy & Neri (2015); Gul & Leung (2004) while proprietary directors are well suited for resource provision, environmental scanning and opportunity seeking (Holderness, 2003; Johnson, Schnatterly, & Hill, 2013; Schnatterly et al., 2008; Tuggle et al., 2010). The board needs both contributions, but in which context is each role particularly relevant? The institutional framework in which the firm makes business will impact the need for management control and resource provision, moderating the relationship between the presence of each kind of director and firm valuation.

The institutional framework of a country is characterized by its local legal system, but the ownership structure of the firm must be also taken inti consideration, since the power of the largest shareholder will impact the effectiveness of directors (Mees & Smith, 2019).

4.3.1 The legal system

The relevance of the legal system was first pointed out by (La-Porta et al., 1998). Civil law is associated with greater government intervention in economic activity and weaker protection of private property than common law, whose vague fiduciary duty principles are more protective of investors than the bright line rules of the civil law (Ergungor, 2002; Zattoni & Cuomo, 2008). There are historical reasons for this: Civil law, since the 19^{th} century, has been an instrument of the State in expanding its power, actually the French and German codes were introduced by Napoleon and Bismarck. Earlier on, Civil law had developed as part of the control that European monarchs retained over their subjects versus the aristocracy. In contrast, Common law developed as a mechanism for protecting the subjects from the crown, with the emphasis on protecting the individual against the government (La-Porta et al., 1997).

Common law countries, versus French, German and Scandinavian civil law countries, provide the strongest degree of protection for shareholders (Djankov et al., 2008). If the law does not protect shareholders from the potential opportunistic behavior of managers, shareholders with enough funds will seek a significant influence on the firm by holding large stakes of equity Peng and Jiang (2010), so that weak investor protection fosters a tendency towards concentrated capital structures. This difference in the legal system and in ownership concentration has implications in terms of the relative effectiveness of independent versus proprietary directors.

Capital dispersion accentuates the separation of ownership and control that makes necessary mechanisms to prevent agents from damaging the principals' wealth (Fama & Jensen, 1983b). In common law countries shareholders' stakes are relatively small, so they are seldom represented in the board and when they do it is not through a controlling stake. US investors rarely hold more than 2% of a public company and "blockholders" or influential stakes are considered with as low as 5%. This dispersed ownership provides CEOs with significant discretion. On the other hand, it is ordinary business for a bank to own 25% of a German public company: this allows influential investors to limit management discretion (Crossland & Hambrick, 2007). La-Porta et al. (1999) defined "closely held" firms as those that have one or more owner with at least 20% of the firm's capital. While 10% of medium-sized U.S. firms were closely held, 70% percent of Japanese firms and 90% of German firms were closely held.

In common law countries, dispersed ownership seldom allows investors to be represented in the board, but the legal system provides sufficient investor protection to rely on independent directors to look after the interests of all shareholders. On the contrary, civil law countries have weaker investor protection environments where the effectiveness of director's independence is often questioned, and the use of outside-independent directors is usually complemented by outside-proprietary directors.

Hypothesis 3: *In Civil Law countries, the positive relationship between high proportion of outside-independent directors and higher firm valuation is weaker than in Common Law countries.*

In contrast, Civil Law countries have a relatively weak legal system of investor protection and firms usually have one or several relevant shareholders that can effectively control management (La-Porta et al., 1999). The role of proprietary directors, appointed by relevant shareholders, is particularly important when firms are performing poorly, since the economic exposure of the main shareholders will drive them to make the necessary adjustments to management practices or even replace the CEO.

In civil law countries, proprietary directors can also contribute to firm performance given their resource provision capabilities. The significant amounts of funds necessary to get board representation are an incentive to commit resources, provide contacts and devote extensive time to assist the management team, given the size of the investment at risk made by the shareholder represented by the proprietary director. Sobhan (2016) provides evidence of this role: institutional investors with presence on the board of directors in Bangladesh reduce overstatement in corporate governance reports. Considering these aspects, we propose that:

Hypothesis 4: *In Civil Law countries, the positive relationship between high proportion of outside-proprietary directors and higher firm valuations is reinforced*

4.3.2 Ownership structure

In civil law counties the conflict between agents and principals is mitigated by a concentrated ownership structure: firms usually have relevant shareholders that can effectively control management. But these concentrated ownership structures give rise to a new conflict of interest between the power of the largest shareholders and minority shareholders –the “principal-principal” conflict. This conflict requires different mechanisms to ensure that minority shareholders are not exploited, this time by large shareholders, rather than by the management of the firm (Young et al., 2008).

In civil law countries, the largest shareholder might particularly fill the institutional void, compensating for lower levels of investor protection. This is also the case of family-controlled groups in emerging countries that pursue significant private benefits of control in weak institutional environments (Jacoby, Liu, Wang, Wu, & Zhang, 2019; Peng & Jiang, 2010b; Young et al., 2008).

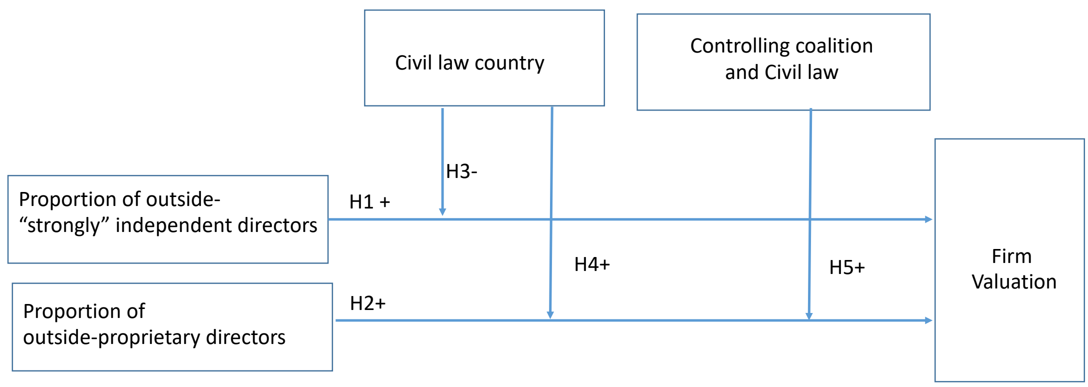
But a group of relevant investors may cooperate and act as a counterbalance to the power of the largest one. A "controlling coalition" may contest the power of the largest shareholder and prevent him from extracting rents from the firm. Once a "controlling coalition" is in place, neither the largest shareholder nor the members of the coalition will be able to control decision making or abuse their position in detriment of minority shareholders (Pagano, Röell, & Zechner, 2002). Both the largest shareholder and the "controlling coalition" may control each other, and all of them, together with independent directors, effectively control managers and foster the valuation of the firm.

It has been discussed how in civil law countries a high number of proprietary directors may benefit the firm, since the significant amounts of funds necessary to get board representation are an incentive to commit resources, provide contacts and devote extensive time to assist the management team. It has been also described how the presence of a "controlling coalition" formed of several large shareholders can mitigate the potential abuse of the largest shareholder. We contend that the positive effect of proprietary directors in civil law countries will be reinforced if the power of the largest shareholder is contested by a "controlling coalition".

Hypothesis 5*: In Civil Law countries,* the presence of a "controlling coalition" increases the positive effect of *proprietary directors on firm valuation.*

As a summary of the model, Figure 2 represent the hypotheses proposed, considering the direct effect of strongly independent directors and proprietary directors on firm value, and the moderating effects of the legal system and controlling coalitions.

Figure 2: Model proposed



4.4 Data

Since we are testing the relationship between the composition of the board of directors and corporate valuation, it is essential that the firms analyzed reach a valuation in the market as efficient as possible. In this vein we examine the market capitalization of companies that are members of the main stock market indexes. The stocks of these companies are actively traded by institutional investors and since liquidity increases the information content of market prices Fang, Noe, & Tice (2009), the valuation of companies belonging to the main indexes will efficiently incorporate public information regarding the company.

Data were obtained from both the annual reports of each company and the ORBIS database. We have analyzed companies belonging to the stock market indexes IBEX35 (Spain), CAC40 (France), BEL20 (Belgium), FTSE100 (UK), OMX30 (Sweden), OMXH25 (Finland) and

OMXC20 (Denmark) during the last year for which data is available (2017). In order to control for each country institutional environment, we exclude foreign companies listed in the stock indexes of these countries, and we also disregard companies in the banking and insurance sectors, given their special regulation, in line with (Acero & Alcalde, 2014). If a company has recently gone public, the lack of track record in the market may impair the causal inference between corporate governance and firm valuation, therefore we have used 10 years cut off for this minimum track record in the stock market to make sure that valuations incorporate corporate governance mechanisms, but the results are robust for a 5-years cut off. This provides us with 174 firms in seven countries: France, Spain and Belgium representing the French-civil law origin; Finland, Denmark and Sweden representing the Scandinavian-civil law origin and the United Kingdom representing common law. We have only analyzed board composition in the European context, to avoid variables different from the legal system from distorting our analysis.

Dependent variable: Firm valuation

Measuring the effectiveness of corporate governance mechanisms, such as different composition of the board of directors, can be achieved through different metrics such as Tobin's Q (Coles, Daniel, & Naveen, 2008; Lins, 2003; Oxelheim & Randøy, 2003; Singh, Tabassum, Darwish, & Batsakis, 2018), return on assets Cornett, Marcus, Saunders, & Tehranian (2007) and stock price returns Baek, Kang, & Park (2004); Field & Lowry (2009); Gompers et al. (2003). We will use Tobin's Q to allow for a combined measure of market perception -market capitalization- and accounting valuation -book value of assets-.

Independent variables: Board of Directors composition

We have researched the composition of the board of directors by means of a thorough investigation of the annual report of each company in our sample.

Regarding independent directors, we use the variable percentage of outside-independent directors to the total number of directors (Miletkov et al., 2014; Suchard, 2009). We have started from the companies' statement of independence about their directors but have investigated further. We define as "*strongly independent directors*" as those who meet two criteria: firstly, they are not members of two additional board of directors and therefore have the necessary time availability to effectively control management, in line with the findings of (Cashman et al., 2012). Secondly, they have joined the board prior to the CEO tenure, following the results of Coles et al. (2014), who found that board monitoring decreases with the fraction of the board comprised of directors appointed after the CEO assumed office. We have reviewed the curricula of 1.977 directors to estimate both dedication and appointment date of each director.

A second variable employed in this research dealing with the board of directors composition is proportion of outside-proprietary directors. Although the variable "proportion of outside directors" has been used in previous research Coles & Hesterly (2000); Neupane & Neupane, (2017), referring to the proportion of directors that are not firm's executives –regardless of whether they are outside-independent or have linkages to the firm's main shareholders-, to the best of our knowledge the variable "proportion of outside-proprietary directors" has not been used before. We are interested in these outside directors that represent relevant shareholders, but except for Spain and Mexico, where corporate governance filings classify directors that represent a significant shareholder as "proprietary", in the rest of countries they are simply considered "outside directors" or even "independent" depending on the size of their shareholding, so we have examined the curricula of every director in our sample to identify those with an affiliation to a relevant shareholder, labelling them as outside-proprietary directors.

Moderating variables

We first consider, as a moderating variable, whether the legal system of the country in which the company is headquartered is “common law” or “civil law”, following (La-Porta et al., 1998). As discussed, in common law countries, dispersed ownership seldom allows investors to be represented in the board, but the legal system provides enough investor protection to rely on independent directors to look after the interests of all shareholders. In contrast, Civil Law countries have a relatively weak legal system of investor protection and firms usually have one or several relevant shareholders that can effectively control management La-Porta et al. (1999) through proprietary directors and also contribute to firm performance through their resource provision capabilities. We have created a dummy variable that takes value “1” for Civil Law countries and “0” otherwise. The countries chosen for this research are representative of each legal system: France, Spain and Belgium represent the French-civil law origin; Finland, Denmark and Sweden represent the Scandinavian-civil law origin and the United Kingdom represents the European common law.

The model also needs to measure the presence of a “*controlling coalition”* formed of several large shareholders that can mitigate the potential abuse of the largest shareholder. A “controlling coalition” may contest the power of the largest shareholder and prevent him from extracting rents from the firm. Once a “controlling coalition” is in place, neither the largest shareholder nor the members of the coalition will be able to control decision making or abuse their position in detriment of minority shareholders (Pagano et al., 2002). Both the largest shareholder and the “controlling coalition” may control each other, and all of them, together with independent directors, effectively control managers and foster the valuation of the firm. Following the criteria set up in Attig, Ghoul, Guedhami, & Rizeanu (2013), we measure the relative weight of a coalition formed by the second and third largest shareholders versus the largest shareholder, computed with their respective voting rights:

$$Controlling\ coalition's\ weight = \frac{VR2 + VR3}{VR1}$$

Where VR2 and VR3 are the voting rights of the second and third shareholders and VR1 are the voting rights of the largest shareholder.

Control variables

The analysis of foreign capital attraction must take into account the *liquidity of the shares* - investors prefer liquid shares that can be bought and sold with less impact on prices (Bushee et al., 2014; Chung & Zhang, 2011; Kim et al., 2011)-. We also include beta calculated over a five-years period and leverage, measured as total liabilities over shareholder's equity, to proxy for various dimensions of risk -firms with higher betas and highly leveraged are perceived as riskier- (Aggarwal et al., 2011; Chung & Zhang, 2011; Ferreira & Matos, 2008; Hadani et al., 2011; Miletkov et al., 2014)-. We control *for firms' growth opportunities* by the firm investments measured by capital expenditure over assets (Aggarwal et al., 2011, 2009; Attig et al., 2013; Bebchuk & Hamdani, 2009; Jafarinejad, Jory, & Ngo, 2015). Since cash-rich firms reach higher valuations, we also compute cash holdings to total assets (Aggarwal et al., 2011; Ferreira & Matos, 2008; Kim et al., 2017).

4.5 Results

We are testing the impact of the relative weight of each kind of outside directors on firm valuation, as measured by Tobin's Q. Table 14 shows the descriptive statistics. Tobin's Q average is 205.11, indicating that the market value of both equity and debt more than doubles the firm's book value. While the average percentage of independent directors is 63.03%, this average of "strongly independent directors" is 14.37%, similar to the average percentage of proprietary directors (12.70%). The average weight of the "controlling coalition" is 0.99, indicating that the second and third largest shareholders voting rights almost compensate for the power of the largest investor.

Table 14: Descriptive statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
Tobin Q	174	205.1138	153.2111	54.68909	958.1732
% Independent	174	63.02609	19.00306	15.38461	100
% True Indep.	174	14.37493	18.26973	0	100
% Proprietary	174	12.69672	15.86566	0	73.33334
Leverage	174	281.6196	1491.062	-599.6629	19675.59
Growth potent.	174	5.273557	6.30365	-11.68365	40.55298
Share liquidity	174	81.5927	62.76956	11.05431	642.2369
Beta	174	0.889975	0.2208603	0.458337	1.983539
Cash over assets	174	10.08282	11.06053	0.01167	89.49967
Civil law sytem	174	0.6724138	0.4706875	0	1
Largest shareholder contested	174	0.9867751	0.5662719	0.0466667	2

TobinQ: (market cap+debt)/assets, **%Independent**: as reported, **%True Indep**: devoted independent appointed prior to CEO, **%Proprietary**: director with ties to shareholder, **Leverage**: total liabilities/shareholders equity, **Growth poten**t: Capex/assets, **Share Liquidity**: annual traded shares/outstanding shares, **Beta**: 5 years beta factor, **Cash over assets**: liquid assets/total assets, **Civil law system**: as reported in La-Porta et al. (1998), **Largest shareholder contested**: relative weight of a coalition formed by the second and third largest shareholders versus the largest shareholder, computed with their respective voting rights: (VR2+VR3) /VR1

Table 15 shows correlation among the variables. We have calculated the variance inflation factors and multicollinearity does not significantly affect coefficient estimation -maximum individual VIF is 2.28 and average VIF is 1.37

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Table 15: Correlation matrix

	Tobin Q	% Independent	% True Indep.	% Proprietary	Leverage	Growth potent.	Share liquidity	Beta	Cash over assets	Civil law sytem	Largest shareholder contested
Tobin Q	1										
% Independent	-0.071	1									
% True Indep.	0.0157	0.3683*	1								
% Proprietary	-0.0266	-0.6879*	-0.2455*	1							
Leverage	-0.0789	0.0813	0.1413	-0.085	1						
Growth potent.	0.2472*	-0.0265	0.034	-0.0383	-0.0709	1					
Share liquidity	-0.1685*	-0.0076	-0.0367	-0.0451	-0.0324	-0.026	1				
Beta	-0.0838	0.1933*	0.1235	-0.1003	0.0171	-0.027	0.1927*	1			
Cash over assets	0.3550*	-0.0478	-0.0454	0.0605	-0.0243	-0.113	0.0991	0.1502*	1		
Civil law sytem	0.0024	-0.3655*	-0.2567*	0.4964*	-0.1338	-0.001	-0.0474	0.102	0.1519*	1	
Largest shareholder contested	-0.0284	0.2689*	0.1256	-0.3577*	0.0785	-0.04	0.1083	0.0082	-0.0239	-0.3325*	1

We have used a Huber estimator -robust standard errors- in models #1, #2 and #3 so that it is not required that the errors follow a normal distribution, nor is it required that they be identically distributed from one observation to the next, therefore our estimation is robust to heteroskedasticity of the errors. Models #4, #5 and #6 use country clusters, which are a generalization of the robust standard errors calculation that relaxes the assumption of independence of the errors and replaces it with the assumption of independence between clusters. Thus the errors are allowed to be correlated within clusters. We compare the results of six models fitted with OLS in Table 17. While the first model includes only control variables, the second and third models incorporate the relative weight of independent and proprietary directors. The measure of independent directors varies across models #2 and #3: while model #2 uses the percentage of independent directors as reported by each firm, model #3 qualifies independence with “strongly independent directors” -among the reported as independent, those who can devote enough time to the board and have been appointed before the CEO tenure-.

Among control variables, leverage is significant at the 5% level, and its coefficient shows that highly leveraged firms are perceived as riskier, impacting their valuation. Growth potential is significant at the 10% level -5% when true independence is considered-, and the positive sign of its coefficient signals the premium that investors are ready to pay for firms with high investment projects that will foster growth.

As discussed, civil law countries are characterized by higher ownership concentration, which makes board representation more likely. Table 16 shows how while in the UK, a common law country, proprietary directors only account for 1%, they reach 30% of the board in Spain, where the law specifically recognizes the right of shareholders to have a board representation proportional to their stakes. Models #4 and #5 analyze the impact of the variable Civil Law as a moderating variable.

Table 16: Board composition by country

		UK	Spain	France	Belgium	Finland	Sweden	Denmark
% independent		73%	44%	55%	48%	91%	57%	53%
% true indepent		21%	8%	7%	4%	23%	15%	8%
% proprietary		1%	31%	17%	27%	7%	15%	12%
Number of firms	174	57	21	30	12	19	21	14
Number of directors	1977	581	272	431	149	146	263	135

It is very interesting that the percentage of independent directors is not significant neither with independence according to firm's statements nor with "strong independence". Only when we add the legal system (model #4), the proportion of strongly independent directors becomes significant at the 5% level and contribute positively to firm valuation.

Analogously, the percentage of proprietary directors is not significant in models #2 and #3, but becomes significant at the 1% once the legal system is incorporated to model #5. The negative coefficient (-5.790) indicates that a higher proportion of proprietary directors causes lower valuation. As the proportion of proprietary directors increases, it is more likely that several of them represent a controlling shareholder who may abuse his position in detriment to minority investors. The joint effect of a high proportion of proprietary directors and civil law has a positive coefficient of 5.554, reflecting the resource provision role discussed, but the total effect of proprietary directors in civil law countries is still negative (5.554-5.790) in this model.

In model #6 we account for the negative factor associated with proprietary directors, that is: the possibility of a powerful largest shareholder. The joint effect of a high proportion of proprietary directors, civil law and a "controlling coalition" that mitigates the power of the largest shareholder is significant at the 5% level, positive (7.502) and higher than the effect of proprietary directors and civil law (5.554).

Table 17: Impact of board composition on firm valuation

	(1) Controls	(2) Reported independence	(3) True Independence	(4) Civil law moderating % True Indep.	(5) Civil law moderating % Proprietary	(6) Largest contested&Civil law moderating % Prop.
Leverage	-0.005**	-0.006**	-0.006**	-0.008**	-0.007**	-0.008**
	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)
Growth potential	6.891***	6.666**	6.807***	6.640*	6.681*	6.463*
	(2.6)	(2.57)	(2.57)	(3.01)	(3.00)	(3.10)
Share liquidity	-0.451***	-0.476***	-0.453***	-0.455**	-0.470*	-0.497*
	(0.14)	(0.16)	(0.15)	(0.19)	(0.19)	(0.21)
Beta	-71.297	-63.671	-78.214	-63.541**	-68.869**	-60.114**
	(48.67)	(51.94)	(47.49)	(21.20)	(22.45)	(24.49)
Cash over assets	5.812***	5.831***	5.892***	5.815***	5.992***	5.979***
	(1.65)	(1.59)	(1.66)	(1.37)	(1.38)	(1.29)
% Independent		-1.027	0.223	1.026***	0.188	0.074
		(0.75)	(0.58)	(0.20)	(0.67)	(0.67)
% Proprietary		-1.468	-0.58	-0.512	-5.790***	5.372**
		(0.93)	(0.64)	(1.37)	(0.88)	(1.48)
Civil law				14.335	-25.408	43.663
				(53.17)	(43.24)	(29.07)
Civil law # % Indep				-1.672*		
				(0.86)		
Civil law # % Prop					5.554**	-4.140**
					(1.91)	(1.68)
Largest contested						72.320***
						(7.47)
Largest contested # % Prop						-9.321***
						(1.40)
Civil law # Largest contested						-51.650*
						(21.98)
Largest contested # %Prop # Civil law						7.502**
						(2.29)
Constant	211.945***	291.698***	222.293***	201.938***	231.101***	138.404***
	(49.83)	(65.59)	(51.91)	(23.75)	(33.41)	(35.65)
R-squared	0.263	0.2754	0.2678	0.2779	0.2749	0.2958
Number of obs.	174	174	174	174	174	174

Standard errors in parentheses using robust standard errors to adjust for heteroskedasticity (columns 1-3) and country clusters (columns 4-6)
The symbols *, **, *** denotate significance at the 10%, 5% and 1% levels, respectively

4.6 Discussion

The extant literature is not conclusive on the contribution of outside directors Chaganti, Mahajan, & Sharma (1985); Daily & Dalton (1992); Dalton et al. (1998); Rechner & Dalton, (1986); Zahra & Stanton (1988), perhaps because of their heterogeneous nature -outside directors may be independent from the firm and its relevant shareholders or independent from the firm but represent a relevant investor-. We have broken down this category of directors into outside-independent and outside-proprietary directors and examined the impact on firm valuation of each category in the light of different institutional frameworks.

Regarding independent directors, the literature has failed to prove a positive relationship between the presence of independent directors and firm performance and valuation (Tung, 2011). The nomination of independent directors does not have to respond to a genuine will to diminish CEO power or to enhance monitoring of the board of directors. As pointed out by Joseph et al. (2014), the adoption of new structures may be shaped by a new legislation or willingness to comply with corporate governance codes. These are examples of "elaboration opportunities that sparks power mobilization and increases the likelihood that structures will be altered in ways that accord with the interests of powerful executives, as well as the expectations of prevailing logics" (Joseph et al., 2014):1851. Public criticism has been constant about the lack of genuinely independent directors: firms may appoint independent directors under pressure from institutional investors' claims and stock market regulations, but if the independence of these directors is not strong enough, it may respond to a cosmetic exercise. Additionally, corporate governance codes include different characterizations of independence (Aguilera, 2005). We build a more stringent definition, "strong independence", built after the findings of Coles et al. (2014) -monitoring decreases with the fraction of the board comprised of directors appointed after the CEO assumed office- and Cashman et al. (2012) -directors with multiple appointments have less time available to effectively control management. In spite of this attempt to refine independence, and in line with the extant literature, we have not found evidence of a general and positive association with firm valuation (hypothesis 1). But once we account for the institutional framework in terms of the legal system (hypothesis 3), our definition of "strongly independent director" provides evidence of a positive contribution to corporate valuation: in common law countries, characterized by low ownership concentration, shareholders do not reach a stake high enough to appoint proprietary directors, but can control managers through strongly independent directors.

Regarding proprietary directors, evidence for the positive impact of their presence in the board of directors (hypothesis 2) is again only provided when taking into consideration the interaction with the institutional framework in terms of legal system (hypothesis 4). We have discussed how the board, besides controlling managers, also serve as a link with the external environment, contributing to resource acquisition, reducing environmental dependency, and aiding in establishing legitimacy (Daily and Dalton, 1994; Daily and Schwenk, 1996; Hambrick and D'Aveni, 1992). Outside directors that represent a significant investor or "proprietary directors" are particularly well suited for this resource provision role. As the ownership stake of the investor increases, he has a greater incentive to increase firm value (Holderness, 2003). But only with ownership concentrations, shareholders reach stakes high enough to appoint proprietary directors. This explains the positive interaction of civil law and proprietary directors (hypothesis 4).

We have also found support for the positive impact on valuation of a joint presence of a controlling coalition, civil law and the proportion of proprietary directors (hypothesis #5). Before considering the relative power of the largest shareholder, the net effect of proprietary directors was negative, since the positive effect of proprietary directors under civil law - resource provision- did not compensate for the negative effect of several proprietary directors representing a powerful largest shareholder, who may abuse his position in detriment to minority investors. But in civil law countries, the joint presence of proprietary directors and a "controlling coalition" that limits the power of the largest shareholder has a positive impact on valuation (Attig et al., 2013; Bennedsen & Wolfenzon, 2000).

4.7 Conclusion

We have investigated why, in spite of the abundant literature focusing on the contribution of outside directors, less biased and theoretically better prepared to judge manager's performance and protect shareholders Fama (1980); Hillman et al. (2000); Mizruchi (2004); Pearce & Zahra (1989); Weisbach (1988), there are no conclusive results on their contribution (Chaganti et al., 1985; Daily & Dalton, 1992; Dalton et al., 1998; Rechner & Dalton, 1986; Zahra & Stanton, 1988). We have revisited the studies of board composition and firm performance with a two-fold approach.

Firstly, we have compensated public criticism about the lack of genuinely outside-independent directors and their nomination to gain legitimacy with a more stringent definition of independence. We have coined the term "strongly independent" after making two adjustments to corporate filings. Firstly, the independent director has necessarily joined the board prior to the CEO tenure, following the results of Coles et al. (2014), who found that board monitoring decreases with the fraction of the board comprised of directors appointed after the CEO assumed office. And secondly, the independent director does not serve in more than two additional boards. directors with multiple appointments have less time available to effectively control management, as shown by Cashman et al. (2012). When we account for the institutional framework, we find statistical significance for the relationship between the proportion of strongly independent directors and firm valuation: this relationship is found to be positive in common law countries.

Secondly, we have been attracted by the scant attention devoted to outside-proprietary directors that represent investors. Outside directors that represent a significant investor or "proprietary directors" are particularly well suited for the resource provision role, in addition to the traditional monitoring role of outside directors. As the ownership stake of the investor increases, he has a greater incentive to increase firm value (Holderness, 2003). The significant amounts of funds necessary to get board representation are an incentive to commit resources, provide contacts and devote extensive time to assist the management team, given the size of the investment at risk made by the shareholder represented by the proprietary director. Since firms generally do not report "proprietary directors" we have examined the curricula of 1977 directors in search of ties with relevant shareholders. Again, we need the institutional context to arrive at a significant finding. We have found that in civil law countries, where ownership concentration allows relevant shareholders to have board representation, the positive effect of proprietary directors does not compensate for the negative effect of several proprietary directors representing a powerful largest shareholder, who may abuse his position in detriment to minority investors. But in civil law countries, the joint presence of proprietary directors and a "controlling coalition" that limits the power of the largest shareholder has a positive impact on valuation.

Our research suffers from the limitation of taking for granted the initial classification of independence assigned by firms to their directors. We have only analyzed board composition in the European context, to avoid variables different from the legal system from distorting our analysis. Future research could develop a worldwide definition of independence and re-classify directors according to this tailor-made definition. This paper has explored different civil law areas: France, Spain and Belgium representing the French origin; and Finland, Denmark and Sweden representing the Scandinavian origin. It would be useful to add the geographical scope by considering civil law countries of German origin, such as Switzerland, Germany or Japan. Additionally, the analysis could be enriched by including common law countries outside Europe, such as the US, Australia or India.

Lastly, both firms and stock market supervisors, may foster practices that our data have proved contrary to shareholders' interest. In this vein the definition of independence could include a limit on the number of external boards and independent director should not be removed from their positions, facilitating not only the effective exercise of their duties in a strongly independent way, but its consolidation as the CEO is renewed. Firms should be transparent regarding the ties of directors to relevant shareholders, since we have shown how proprietary directors can contribute to share-value creation, in civil law countries, particularly when a controlling coalition is in place.

Chapter 5. Monitoring by blockholders and independent directors

5.1 Introduction

The need for corporate governance arises from the separation of ownership and control that may lead to managers or "agents" to behave opportunistically in detriment of minority shareholders or "principals" (Fama & Jensen, 1983a; Jensen & Meckling, 1976). And capital dispersion accentuates the need for corporate governance: managers will find it easier to divert corporate assets, to follow corporate strategies that yield them personal benefits of control, to resist to value-increasing takeovers, to receive excessive compensation or simply to manage inefficiently if management control is diluted by the vast group of shareholders present in public companies. Ownership structure -the type of investors and the size of their stakes- is considered by itself a corporate governance mechanism related to firm value (Edmans & Holderness, 2017). Blockholders, who gather significant stakes at public companies, are a relevant actor in ownership structure and corporate governance.

Moreover, differences in the institutional framework of the countries where firms are located precede ownership concentration and its influence on corporate governance. Common law countries provide the strongest degree of protection for shareholders and dispersed ownership structures are common among them. In these countries the founding families of a firm feel comfortable diluting their stake and eventually becoming minority investors, minority shareholders also feel comfortable investing in a firm where the founding family still holds a significant stake, and professional managers run the daily operations of the company.

But when the law does not protect shareholders from the potential opportunistic behavior of managers, shareholders will seek a significant influence on the firm by holding large stakes of equity, leading to concentrated ownership structures, as is the case in French, German and Scandinavian civil law countries (La-Porta et al., 1998). In the absence of proper legal protection, not only capital will remain concentrated but families will manage their firms directly, not risking to hire professional managers (Peng & Jiang, 2010b). Concentration of ownership can compensate for the problem of separation between ownership and control.

But even in countries with relatively dispersed ownership structures, shareholders often choose to accumulate significant stakes. In a random sample of manufacturing firms in the US, 56% of companies had shareholders holding over 5% of the firm's capital (Mehran & Carroll, 1995). While the regulatory need to report holdings over 5% has led to define blockholders at that level, the literature refers to large shareholders as those with at least 10% of capital and to controlling shareholders as those with over 20% of capital. La-Porta et al. (1999) defined "closely held" firms as those that have one or more owner with at least 20% of the firm's capital. While 10% of medium-sized U.S. firms were closely held, 70% percent of Japanese firms and 90% of German firms were closely held.

Corporate governance mechanisms are internal to the firm –board composition, compensation and ownership structure- and external, namely the legal system and the role that competition plays in different markets –product, labour and takeover markets- (Denis & McConnell, 2003). The study of blockholders is part of the literature dealing with an internal mechanism: ownership structure.

In this sense, this paper firstly tries to contribute by providing further theoretical base about the relationships between the presence of blockholders and firm value. Although this relationship has been broadly analyzed in previous research, findings are not conclusive (Cremers & Nair, 2005; Faccio, Lang, & Young, 2001; Farber, 2005; Holderness, 2003; Holderness & Sheehan, 1985; Lins, 2003; Lins & Warnock, 2004). Since independent directors are one of the most analyzed and diffused corporate governance mechanism, we also try to contribute by both sharpening their definition with the notion of "strongly independent directors" and by exploring the joint relationship between the proportion of strongly independent directors, blockholders capital and firm valuation. We find statistical significance for a joint and positive relationship between the proportion of strongly independent directors, blockholders capital and firm valuation. Independent directors seem to act as complement to the presence of blockholders.

In this study we posit that this lack of previous confirming results is due to the fact that blockholder bring improved monitoring and improvements in firm's value -shared benefits of control- but also may abuse their position and extract rents from the firm or "private benefits of control" Holderness (2003), particularly if the blockholders is a controlling shareholder Young et al. (2008) who diverts corporate resources for private consumption as in the "tunneling" or transferring of funds out of the firm (Johnson et al. 2000). In this case, instead of the traditional "principal-agent" conflict between managers and shareholders, there is a "principal-principal" conflict between blockholders and minority shareholders. We finally try to contribute by exploring the relationship between the presence of a controlling shareholder, the volume of the remaining blocks and firm value. We find statistical significance of the presence of a controlling shareholder, mitigated by the volume of the remaining blocks. We also find statistical significance for the positive effect on valuation of the presence of a controlling coalition between the second and third shareholders, who can compensate for the power of the largest investor. The net effect on valuation of blockholders will depend on the relative power of this coalition: if the sum of blockholders capital is high enough, either the largest shareholder or the coalition may become a controlling one, negatively impacting valuation.

5.2 Blockholders: shared and private benefits of control

Minority shareholders face a free rider problem to afford management monitoring, an expensive and time consuming activity necessary to prevent managers from behaving opportunistically. In the case of blockholders, the size of their stake makes it worthwhile to dedicate resources to monitoring and getting involved with corporate decision making. If the blockholders' stake is big enough, the shareholder may be represented at the board of directors as proprietary director. Although stock market regulations will prevent him from trading during certain periods -i.e. prior to financial or corporate announcements-, the presence of a proprietary director will allow the investor to access management and corporate information frequently, enhancing company monitoring and resulting in an informed view on the company. Blockholders that are also proprietary directors partially compensate for the agency problems derived from the separation of ownership and control (Shleifer and Vishny, 1986) (Agrawal and Mandelker, 1990) (Chung et al., 2002).

Blockholders are shareholders with a relevant stake in the firm that allows them to gather more information on the firm than minority shareholders (Edmans & Manso, 2011). An insider -i.e. a manager or director- can also accumulate a block of shares, but stock market regulation will prevent him from benefiting from this informational advantage, so this definition focus on outside blockholders that can build and benefit from an informational advantage. There is no empirical threshold for the stake considered a block, but based on existing regulation, most research considers the presence of blockholders on stakes beyond 5%.

The size of blockholders' stakes grants them access to the firm's management, provides incentives to afford detailed and expensive analysis of corporate information and may also lead to decision-making power derived from the political rights of his stake -directors nomination and decisions adopted at the shareholders meeting-. When investors forgo the benefits of diversification and concentrate capital in a block they pursue both shared and private benefits of control (Holderness, 2003).

Shared benefits of control derive from the fact that the higher the stake, the higher is total risk assumed by the investor, who will also have higher incentives for monitoring and increasing firm value. The increase in firm value that results from blockholders' intervention is shared by all shareholders (Claessens et al., 2002; Shleifer & Vishny, 1986).

But blockholders may enjoy advantages that are not shared with minority investors -private benefits of control-. This would be the case of a blockholder who is a firm that enjoy synergies with the company where it holds the stake or, on a more negative note, if the blockholder is diverting corporate resources for its private consumption as in the "tunneling" or transferring of funds out of the firm. In this case, instead of the traditional "principal-agent" conflict between managers and shareholders, there is a "principal-principal" conflict between blockholders and minority shareholders, particularly if the blockholder is a controlling shareholder (Young et al., 2008). Controlling shareholders are blockholders with the capacity to exert influence on the company management, not necessarily with a majority stake. We will refer to "controlling shareholders" as those blockholders with over 20% of capital, in line with (La-Porta et al., 1999).

The potential abuse by controlling shareholders can be performed by direct ownership or by control enhancing mechanisms designed to achieve high control rights without the equivalent proportion of ownership -cash flow rights-, such as the use of pyramids and dual class shares - shares with differential voting rights-. In this vein Claessens et al. (2002) found that the difference between ownership -cash-flow rights- and political rights is negatively related to corporate valuation, suggesting that entrenched shareholders may exert their influence to extract rents from the firm. Nguyen Thi (2018) found evidence of firm value decreasing as the controlling shareholder increases his stake -reflecting a positive relationship between power and expropriation-, until 45% of capital is reached: from this point onwards, the controlling shareholder has the power to expropriate minority shareholders but his incentives decrease due to private gains being lower.

Therefore, the impact of blockholders presence on firm value will depend on the trade-off between share benefits of control, enjoyed by all shareholders, and those private benefits of control that are detrimental to minority investors. A bigger stake in the company increases the incentives to monitor management and reduce agency problems, unless the stake becomes big enough to generate expropriation incentives: the blockholder may use his political rights to influence the firm towards the adoption of decision that are in his interest, rather than the firm's. This is consistent with the results of Park et al. (2008), who find evidence of a positive market reaction to outside block formation after removing from their sample majority control blocks. In the same line, Schnatterly et al. (2008) argue that large institutional owners have an informational advantage in terms of access to management, economies of scale in the acquisition of information due to the size of their investments and expertise in processing financial information, improving their monitoring capabilities.

Lastly there is evidence of a learning curve for blockholders, as shown by Kang et al. (2018): the experience obtained from holding multiple blocks in different companies reduces monitoring costs and improves the blockholders capabilities. Better monitoring is achieved when investors have block holdings in several companies of the same industry, when they keep them over long periods of time or when they have prior experience in firm intervention.

5.3 Blockholders actions and firm value

Blockholders gain an informational advantage through monitoring, but how do they profit from this advantage? Blockholders have two options: firstly, they can interact with the management team to influence the running of the business, exerting "voice" through an informal dialogue with the management team or voting at the annual shareholder meeting. Secondly, they can sell their shares -the "exit strategy" or "wall street walk" (Chen, Harford, & Li, 2007)-. And it is not even necessary that blockholders actually influence the company's management or sell their shares: the mere threat of doing so may foster managers action and influence firm value (Admati & Pfleiderer, 2009).

Evidence of the benefits of blockholder intervention can be found in Farber, (2005)- firms that have manipulated their financial statements have less blockholders- and in Brav, Jiang, Partnoy,

& Thomas (2008) - success in limiting CEO compensation and removing poor performing CEOs.

Regarding intervention, blockholders face a free-rider problem: actively intervening a firm is costly– promoting the removal of an underperforming CEO, opposing a value destroying M&A transaction, advising the management team, etc.- and all shareholders will benefit from it in spite of the intervening blockholder assuming most of the costs. As discussed, as blockholders increase the size of their participation in the company, they assume more risk relative to the size of their portfolio and increase their incentives to intervene and improve the management of the company. Also, as the size of the block increases, it becomes harder to sell without affecting the price, and this liquidity problem leads to higher intervention as blockholders may have to keep their investment for longer periods (Park et al., 2008).

In contrast with intervention, the smaller the size of the block, the easier becomes exit, since it is possible to sell the block without affecting the price. This is the case when there are a large number of blockholders: both its lower size and the increased difficulty to implement a coordinated intervention favor the exit strategy (Edmans & Manso, 2011). The size of blockholders' investment provide them with incentives to monitor and gather valuable information, so blockholders trades contain private information that improves the stock price informativeness (Edmans, 2014). Trading by blockholders will be more effective as the blockholder invest more of his own money. As shown by Dasgupta and Piacentino (2015), the threat of exit loses credibility in the case of money managers that compete for investor capital as fiduciary investors, managing money for others and facing short term incentives. On the contrary, as the fund self-invests in the company, long term incentives arise and threat of exit becomes an effective mechanism.

The threat of exit is an incentive for managers to perform, since a disappointed blockholder selling its stake might cause a drop in the stock price, negatively impacting on the top management compensation that is linked to the stock price. But exit, and not only the threat of it, may end up being the rational response by blockholders that are disappointed with firm performance and do not succeed in persuading the management team to change its course of action or do not gather enough votes at shareholders meetings. Effective exit, although a radical outcome, is not a rare mechanism: in a corporate governance survey conducted by McCahery, Sautner, & Starks (2016) among institutional investors, 49% stated that dissatisfaction with performance had led them to exit a firm.

As previously referred, extant literature refers to large shareholders as those with at least 10% of capital and to controlling shareholders as those with over 20% of capital (La-Porta et al., 1999). But it does not take neither a large blockholder nor a controlling blockholder to gain access to management and to be able to analyze the firm in detail, gaining a valuable private information. Blockholders have the incentive and resources to perform effective monitoring and influence the firm's management, opposing managers actions that are not aligned with shareholders' interest -i.e. a dilutive acquisition- and fostering decisions that lead to value creation -i.e. substitution of underperforming CEOs-. Since blockholders will either intervene or sell their shares if managers underperform, their presence in the capital is a positive signal for other investors. We therefore formulate the following hypothesis:

Hypothesis 1: *Firms where blockholders' ownership is high achieve higher valuations.*

Blockholders have incentives to monitor managers, to provide advice, prevent value-destroying acquisitions from being executed or even remove underperforming CEOs. This intervention in the firm, together with the credible threat of selling their shares if underperforming managers do not correct their course of action, mitigate the potential conflict of interest between managers and owners. But we have also discussed that the presence of shareholders with a relevant stake increase the probability of a controlling shareholder abusing his power in detriment to the rest of minority shareholder. In addition to the traditional "principal-agent" conflict between managers and shareholders, a new agency problem arises in the presence of a controlling shareholder: the controlling shareholder may try to extract rents from minority shareholders -a "principal-principal" conflict (Young et al., 2008)-. Alternatively to the presence of a controlling shareholders, a group of them could form a coalition Bennedsen & Wolfenzon (2000) or even cooperate to extract rents from the firm (Attig et al., 2013; Faccio et al., 2001). This abuse can be prevented through corporate governance mechanisms such as the control exerted by independent directors, but as ownership concentration increases, the cost of these mechanisms is increasingly borne by the controlling shareholder, reducing his incentives to implement them (Barroso, Burkert, Dávila, & Oyon, 2016). But if the company has a second large shareholder who acts as "monitor of controlling shareholders", both of them will control each other and together will control the management team (Pagano & Roell, 1998). If the company has a controlling shareholder whose power is not contested by a second large shareholder, blockholders will not be able to influence the firm and the monitoring benefits associated to their presence will be offset but the controlling shareholder. Based on that, we propose the following:

Hypothesis 2: *Firms where blockholders ownership is high but have a controlling shareholder achieve lower valuations than those without a controlling shareholder.*

Firms with several large investors may benefit from their increased monitoring, but if the dispersion of ownership concentration across multiple large shareholders is high, corporate valuation may suffer (Laeven & Levine, 2008).

The more even is the distribution of voting rights, the less likely is the firm to suffer from agency problems Attig et al. (2013) and the lower the cost of equity capital will be Attig, Guedhami, & Mishra (2008), probably because the presence of multiple blockholders with comparable voting power improves the firm's information quality and prevents abuse by the largest shareholder. Maury and Pajuste (2005) also provides evidence for the relevance of the contestability of the largest shareholder, since controlling shareholders tend to extract rents from the firm unless they are monitored by another large blockholder (Claessens et al., 2002).

The extreme case of ownership dispersion would be that of a single blockholder in the capital structure that is also a controlling shareholder. The controlling shareholder will effectively control management La-Porta et al. (1998), therefore mitigating the conflict between agents and principals. But in the absence of any blockholder with a stake big enough to challenge his control, the controlling shareholder may try obtain private benefits of control by extracting rents from minority shareholders -a "principal-principal" conflict (Peng & Jiang, 2010b; Young et al., 2008) -.

The presence of multiple blockholders is an effective mechanism for investor protection, since their joined efforts improve management monitoring and prevent rent extraction from the controlling shareholder, therefore mitigating both the principal-agent and principal-principal problems. More than 35 percent of European firms Laeven & Levine (2008), have not one, but multiple large shareholders -blockholders with at least 10% of capital-. The presence of multiple large blockholders increases the contestability of the largest shareholder's control and investors may perceive it as an effective monitoring mechanism, since blockholders will try to influence the company before affording the costs of exiting -avoiding potential losses associated to a declining selling price, transaction and tax expenses, portfolio adjustments, etc.-. The presence of several blockholders may challenge the power of the largest blockholder and prevent rent extraction from the firm. Therefore we formulate the following hypothesis:

Hypothesis 3: *Firms where blockholders ownership is high and the relative power of the main shareholder is low achieve higher valuations than those where the relative power of the main shareholder is high.*

Additionally, to the monitoring that blockholders conduct, the board of directors exerts direct monitoring on management, who is accountable to the board on behalf of all shareholders of the company. Convergence towards the Anglo-Saxon model of corporate governance has underpinned codes of corporate governance diffusion (Aguilera & Cuervo-Cazurra, 2004). Codes of good corporate governance include widely shared recommendations across countries and firms adopt them to gain legitimation Tolbert & Zucker (1983) in the global capital markets. A corporate governance recommendation widely implemented in companies all over the world is to include a high proportion of independent directors in the board (Cumming et al., 2017).

Although theoretically independent directors, given the absence of ties with the management team, are well positioned to protect all minority investors, the definition of independence is challenging, as it varies depending of the code of corporate governance of each country. While in the US independence is presumed for any director who is not an executive or shareholder with over 10% of capital, in Europe corporate governance codes include detailed and different characterizations of independence, sharing family ties and former employment relationships as disqualifying features for independence (Aguilera, 2005). Public criticism has been constant about the lack of genuinely independent director at public companies and several studies have failed to prove a positive relationship between the presence of independent directors and firm performance (Tung, 2011).

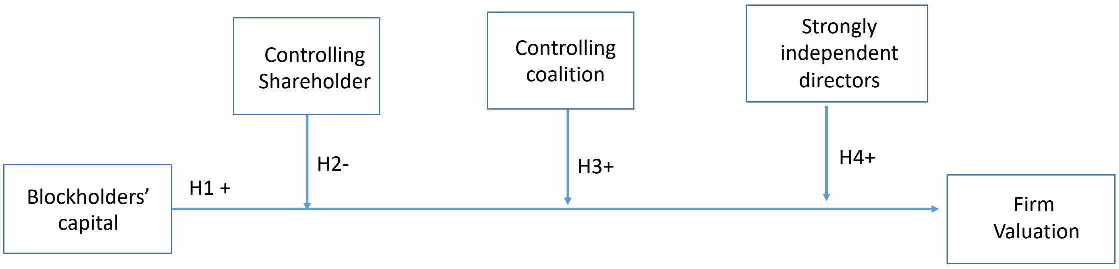
Setting up a minimum proportion of independent directors may be a corporate governance mechanism aimed at gaining legitimacy, but we wonder to which extent it responds to genuine will to protect shareholders or to what Meyer and Rowan (1977) called “myth and ceremony”. A more stringent definition or “strong independence” can be obtained after making two adjustments to formal classifications of “independent” directors. Firstly, the independent director has necessarily joined the board prior to the CEO tenure, following the results of Coles et al. (2014), who found that board monitoring decreases with the fraction of the board comprised of directors appointed after the CEO assumed office. And secondly, the independent director does not serve in more than two additional boards. Although multiple directorships were initially considered a certification of a director's abilities Fama & Jensen (1983b), directors with multiple appointments have less time available to effectively control management, as shown by (Cashman et al., 2012). Actually CEOs have been found to prefer "independent" directors with multiple board directorships Shivdasani & Yermack (1999) and firms with a majority of outside directors serving in multiple boards have worse performance and are less likely to fire the CEO (Fich & Shivdasani, 2006).

As the total capital accumulated by blockholders increases, it becomes more likely to find a controlling shareholder or several shareholders able to form a coalition acting in detriment of minority investors. In this context of high capital held by blockholders, a high proportion of strongly independent directors, given their lack of ties with the management team, may be capable of preventing abuse by relevant shareholders and effectively monitoring the firm (Grosman, Aguilera, & Wright, 2018). We therefore propose the following hypothesis:

Hypothesis 4: *Firms with a high proportion of strongly independent directors and high proportion of blockholders' capital achieve higher valuations.*

As a summary of the model, Figure 3 represent the hypotheses proposed, considering the direct effect of blockhlders' capital on firm value, and the moderating effects of controlling shareholders, the presence of a controlling coalition and a high proportion of strongly independent directors.

Figure 3: Model proposed



5.4 Data

Since we are testing the relationship between the presence of blockholders and corporate valuation, it is essential that the firms analyzed reach a valuation in the market as efficient as possible. In this vein we examine the market capitalization of companies that are members of the main stock market indexes. The stocks of these companies are actively traded by institutional investors and since liquidity increases the information content of market prices Fang et al. (2009), the valuation of companies belonging to the main indexes will efficiently incorporate public information regarding the company.

Data were obtained from both the annual reports of each company and the ORBIS database. We have analyzed 174 firms in seven countries–Spain, France, Belgium, UK, Sweden, Finland and Denmark-, so that different ownership structures are included. We have analyzed companies belonging to the stock market indexes IBEX35 (Spain), CAC40 (France), BEL20 (Belgium), FTSE100 (UK), OMX30 (Sweden), OMXH25 (Finland) and OMXC20 (Denmark) during the last year for which data is available (2017). We exclude foreign companies listed in the stock indexes of these countries, so that we can control for the local ownership structure, as well as companies in the banking and insurance sectors -given their special regulation- and companies without a track record as quoted companies long enough. We have used 10 years cut off for this minimum track record in the stock market to make sure that valuations incorporate the effects of corporate governance mechanisms, but the results are robust for a 5-years cut off.

Dependent variable: Firm valuation

Measuring the impact of blockholders monitoring can be achieved through different metrics such as Tobin's Q (Coles et al., 2008; Lins, 2003; Oxelheim & Randøy, 2003; Singh et al., 2018), return on assets Cornett et al. (2007) and stock price returns (Baek et al., 2004; Field & Lowry, 2009; Gompers et al., 2003). We will use Tobin's Q to allow for a combined measure of market perception -market capitalization- and accounting valuation -book value of assets-.

Independent variable: Blockholders capital

We have researched the impact of blockholders in the firm's capital by examining the total share of capital held by this kind of investors. There is no empirical threshold for the stake considered a block, but since disclosure regulation provides information on stakes beyond 5%, this is the threshold commonly used in the literature (Acero & Alcalde, 2014; Dai, Dharwadkar, Si, & Zhang, 2017; Dasgupta & Piacentino, 2015; Edmans & Holderness, 2017; Holderness, 2003; Nguyen Thi, 2018). We construct our independent variable as the sum of all stakes equal to or higher than 5%.

Moderating variables

Firstly, we measure the impact of a controlling shareholder on the effectiveness of blockholders as monitors. We identify *controlling shareholder*s as those holding at least 20% of capital, in line with La-Porta et al. (1999) and Faccio & Lang (2002). Our hypothesis is that the presence of a controlling shareholder is a deterrent for other investors, unless there is other relevant shareholder and both monitor each other (Pagano & Roell, 1998). We refer to this second kind of relevant shareholder as "monitors of controlling shareholders". Following the criteria set up in La-Porta et al. (1999), we consider 10% as sufficient for monitoring the *controlling shareholder*. We have gathered data for the identification of "controlling shareholders" (+20%) and "monitors of controlling shareholders" (+10%) from the filings that all shareholders with more than 5% of a listed company must disclose. We have also computed the variable "majority" to measure the impact of a majority investor with over 50% of capital on the effectiveness of blockholders monitoring.

The model also tests a second moderating effect: the presence of a "*controlling coalition*" that controls the power of the largest shareholder, so that both monitor each other (Pagano & Roell, 1998). Following the criteria set up in Attig et al. (2013), we measure the relative weight of a coalition formed by the second and third largest shareholders versus the largest shareholder, computed with their respective voting rights:

$$Controlling\ coalition's\ weight = \frac{VR2 + VR3}{VR1}$$

Where VR2 and VR3 are the voting rights of the second and third shareholders and VR1 are the voting rights of the largest shareholder.

Lastly, and regarding independent directors, we have computed the average percentage of *strongly independent directors* in our sample, which equals 14%. We use a dummy variable that equals 1 if the percentage of true independent directors is higher than this average value. To arrive at the definition of "strong independence", we have started from the companies' statement of independence about their directors but have investigated further. We define as "strongly independent directors" as those who meet two criteria: firstly, they are not members of two additional board of directors and therefore have the necessary time availability to effectively control management, in line with the findings of Cashman et al. (2012). Secondly, they have joined the board prior to the CEO tenure, following the results of Coles et al. (2014), who found that board monitoring decreases with the fraction of the board comprised of directors appointed after the CEO assumed office. We have reviewed the curricula of 1.977 directors to estimate both dedication and appointment date of each director.

Control variables

The analysis of corporate valuation must take into account the *liquidity of the shares* -investors prefer liquid shares that can be bought and sold with less impact on prices (Bushee et al., 2014; Chung & Zhang, 2011; Kim et al., 2011)-. We also include *leverage*, measured as total liabilities over shareholder's equity, and beta, calculated over a five-years period, to proxy for various dimensions of risk -firms with higher betas and highly leveraged are perceived as riskier- (Aggarwal et al., 2011; Chung & Zhang, 2011; Ferreira & Matos, 2008; Hadani et al., 2011; Miletkov et al., 2014)-. We control for *firms' growth opportunities* by the firm investments measured by capital expenditure over assets (Aggarwal et al., 2011, 2009; Attig et al., 2013; Bebchuk & Hamdani, 2009; Jafarinejad et al., 2015). Since cash-rich firms reach higher valuations, we also compute cash holdings to total assets (Aggarwal et al., 2011; Ferreira & Matos, 2008; Kim et al., 2017). Lastly, we control for *heterogeneity between the two largest shareholders* of the firm. Families, individuals or institutions investing their own money are beneficiary shareholders and have strong incentives to get involved in the firm management, while fiduciary shareholders that invest other people's money – banks, corporations, the State, mutual and pension funds- may engage with management to a lesser extent (Connelly, Tihanyi, Certo, & Hitt, 2010). Heterogeneity makes it more difficult to cooperate among investors, so when the two largest shareholders belong to different categories, firm valuation is negatively impacted (Laeven & Levine, 2008). We use a dummy variable that equals 1 if the first and second largest shareholders are of different nature.

5.5 Results

Table 18 presents the main descriptive statistics of the variables. As it can be observed, the average block capital is over 36%, controlling shareholders -without another shareholder able to "monitor" them- are present in 27% of firms, only 15% of firms have a majority shareholder and the coalition formed by the second and third investors almost equals the largest shareholder in terms of voting rights.

Table 18: Descriptive statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
Tobin Q	174	205.1138	153.2111	54.68909	958.1732
Blocks	174	36.08345	21.80556	0	92.76
Leverage	174	281.6196	1491.062	-599.6629	19675.59
Growth potent.	174	5.273557	6.30365	-11.68365	40.55298
Share liquidity	174	81.5927	62.76956	11.05431	642.2369
Beta	174	0.889975	0.2208603	0.458337	1.983539
Cash over assets	174	10.08282	11.06053	0.01167	89.49967
Heterogenous investors	174	0.5172414	0.5011448	0	1
Controlling 20%	174	0.2701149	0.4453004	0	1
Largest shareholder contested	174	0.9867751	0.5662719	0.0466667	2
Controlling 50%	174	0.1551724	0.3631139	0	1
High true independent	174	0.4022989	0.4917768	0	1

TobinQ: (market cap+debt)/assets, **Blocks**: aggregated capital of all investors holding at least 5%, **Leverage**: total liabilities/shareholders equity, **Growth potent**: Capex/assets, **Share Liquidity**: annual traded shares/outstanding shares, **Beta**: 5 years beta factor, **Cash over assets**: liquid assets/total assets, **Heterogenous investors**: dummy=1 if 1st and 2nd largest shareholders are of different nature, **Controlling 20%**: largest shareholder controls at least 20% of voting rights and no other investor reach 10%, **Largest shareholder contested**: relative weight of a coalition formed by the second and third largest shareholders versus the largest shareholder, computed with their respective voting rights: (VR2+VR3) /VR1, **Controlling 50%**: largest shareholder controls at least 50% of voting rights **High true independent**: proportion of independent directors that have joined the board prior to the CEO tenure and have no more than 2 outside boards is over the mean (14%)

Table 19 shows correlation among the variables. The presence of a controlling shareholder with at least 20% is correlated with the controlling coalition's weight, since that the later is the sum of the second and third shareholders votes divided by the largest shareholder. Analogous relations explain correlations between "controlling coalition" and "controlling 50%" and "controlling 20%". We have calculated the variance inflation factors and multicollinearity does not significantly affect coefficient estimation -maximum individual VIF is 3.92 and average VIF is 1.74-

Table 19: Correlation matrix

	Tobin Q	Blocks	Leverage	Growth potent.	Share liquidity	Beta	Cash over assets	Heterogenous investors	Controlling 20%	Controlling coalition	Controlling 50%	Strongly independent
Tobin Q	1											
Blocks	0,1278	1										
Leverage	-0,0789	-0,0226	1									
Growth potent.	0.2472*	-0,0148	-0,0709	1								
Share liquidity	-0.1685*	-0,1017	-0,0324	-0,0257	1							
Beta	-0,0838	0,0832	0,0171	-0,0267	0.1927*	1						
Cash over assets	0.3550*	0,0598	-0,0243	-0,1134	0,0991	0.1502*	1					
Heterogenous investors	-0.1549*	0.2071*	-0,0973	-0,0436	0,0246	0,0843	0,075	1				
Controlling 20%	0,0267	0.4938*	-0,0641	0,0504	-0,0798	-0,027	0,0229	0.2251*	1			
Controlling coalition	-0,0284	-0.4951*	0,0785	-0,0401	0,1083	0,0082	-0,0239	-0.2507*	-0.8275*	1		
Controlling 50%	0,1484	0.5605*	-0,0546	0,0453	-0.2138*	-0,09	0,0772	0,1282	0.7045*	-0.6409*	1	
Strongly independent	-0,0526	-0,0539	0,1063	0,0395	-0,032	0.2658*	-0,0491	-0,0283	-0,0504	0,1116	-0,125	1

Correlation coefficients, * denotes significance at the 5% level

Table 20 shows the prevalence of blockholders across countries in the sample. Although the total capital accumulated by blockholders is lower in UK -due to the scarcity of controlling shareholders-, they represent a significant share of total capital across all countries in the sample: 26% in the UK and between 35% (France) and 48% (Spain) in the rest of countries. This reflects the fact of a higher ownership concentration in civil law countries: the lower investor protection is, the more investors protect themselves accumulating significant stakes. While the largest shareholder controls 12% of capital in the UK, this percentage is between 22% (France) and 36% (Denmark) in civil law countries.

Table 20: Blockholders and Controlling shareholders by country

	UK	Spain	France	Belgium	Finland	Sweden	Denmark
Blockholders capital	26%	48%	35%	43%	44%	38%	45%
Number of blockholders	3.04	3.38	2.37	2.25	2.63	2.38	2.21
Average block	8%	14%	15%	19%	17%	16%	20%
Average stake of largest shareholder	12%	29%	22%	34%	27%	27%	36%
Average stake of 2nd largest shareholder	7%	9%	8%	7%	11%	8%	6%
Average stake of 3rd largest shareholder	5%	6%	6%	4%	7%	5%	4%
% Firms with controlling shareholder	12%	57%	40%	75%	47%	67%	50%
% Firms with majority shareholder	2%	29%	17%	25%	21%	10%	43%
Number of firms 174	57	21	30	12	19	21	14

Blockholders capital: average aggregated capital of all stakes greater than 5%, **Number of blockholders**: average number of shareholders with over 5% of capital, **% Firms with controlling shareholder**: percentage of firms with an investor holding over 20% of capital and no other investor reaching 10%, **% Firms with majority shareholder:** percentage of firms where an investor holds over 50% of capital

While the average firm in the UK has 3 blockholders holding 8% of capital each, in Denmark that average firm has 2.2 blockholders with 20% of capital each. While in the UK only 12% of companies have a controlling shareholder, this percentage increases to between 40% (France) and 75% (Belgium) in the rest of the sample. The most significant figure about ownership concentration may be the percentage of firms with a majority shareholder: 2% in the UK and between 17% (France) and 43% (Denmark) in the rest of the sampled countries.

According to the model proposed, in Table 21 it is tested the impact of the presence of blockholders on firm valuation, as measured by Tobin's Q. We have used a Huber estimator -robust standard errors- in models #1 and #2 so that it is not required that the errors follow a normal distribution, nor is it required that they be identically distributed from one observation to the next, therefore our estimation is robust to heteroskedasticity of the errors. Models #3 to #6 use country clusters, which are a generalization of the robust standard errors calculation that relaxes the assumption of independence of the errors and replaces it with the assumption of independence between clusters. Thus the errors are allowed to be correlated within clusters. We compare the results of six models fitted with OLS. While the first model includes only control variables (model#1), the second model add as independent variable the aggregated capital of all blockholders (model #2). The third and fourth models incorporate the presence of a controlling shareholder with over 20% of capital and no other shareholder with at least 10% of voting rights that would allow to act as "monitors of the controlling shareholders", (model #3) and the presence of a majority shareholder, with over 50% of capital (model #4). The fifth model considers the power of the collation formed by the second and third largest shareholders versus the largest shareholder (model #5) and the sixth and last model tests the impact on valuation of the joint presence of blockholders and a high proportion of "strongly independent directors" -among the reported as independent, those who can devote enough time to the board and have been appointed before the CEO tenure-.

The share of capital owned by blockholders is not significant until we incorporate the moderating variable "controlling coalition". The relative power of a collation formed by the second and third largest shareholders is significant at the 5% and has a positive impact on firm valuation (coefficient +72.761), although its net impact will be lower depending on the sum of blocks capital (coefficient -1.395). This is a sensible result since at the sum of blocks capital increases, it becomes more likely to have a controlling shareholder or controlling coalition.

The presence of a controlling shareholder with over 20% of capital, not compensated with the presence of another shareholder with at least 10% of capital, is negative for firm's value (coefficient of -113.15), although the presence of a high proportion of blockholders moderates this negative impact (coefficient of +1.1915). As more blockholders are added, even if none of them reach 10%, their joint presence is a deterrent for abuse by the controlling shareholder. This situation is more pronounced in the case of a majority shareholder with over 50% of capital: although the negative impact on valuation of a majority is very high (coefficient -344.02), the joint presence of blockholders and majority has a very positive impact (coefficient of 5.488). Once a firm has a majority shareholder, it will be very rare to have a blockholder different from the majority investor. But should the firm have a second blockholder, its presence will be valued very positively: there is a blockholder that trust the majority shareholder.

It is very interesting that the variable high percent of strongly independent directors is not significant by itself, but the joint effect of high percent of strongly independent directors and blockholders is significant at the 5% level and positively associated with firm valuation (coefficient +1.481).

Among control variables, leverage is significant at the 5% level -1% when blocks are considered-, and its coefficient shows that highly leveraged firms are perceived as riskier, impacting their valuation. Growth potential is significant at the 1% level -10% when interactions are considered-, and the positive sign of its coefficient signals the premium that investors are ready to pay for firms with high investment projects that will foster growth. Share liquidity does not show an intuitive sign, probably because of its high correlation with firm beta, which makes its individual point estimates not always reliable. Cash holdings to total assets is significant at the 1% level -5% when accounting for a controlling shareholder- and its positive coefficient reflects the fact that cash-rich firms reach higher valuations. Lastly, we control for heterogeneity between the two largest shareholders of the firm and find a negative impact on valuation, reflecting the difficulty to cooperate between heterogenous investors, although the level of significance varies between 1% and 10% depending on the model.

Table 21: Blockholders and firm valuation

	(1) Controls	(2) Blocks	(3) Controling 20% moderating blocks	(4) Controling 50% moderating blocks	(5) Largest shar. contested moderating blocks	(6) High true independent moderating blocks
Leverage	-0.007**	-0.007***	-0.007**	-0.007**	-0.007**	-0.007**
	0	0	0	0	0	0
Growth potential	6.717***	6.726***	6.699*	6.908*	6.556*	6.760*
	(2.5)	(2.48)	(3.09)	(3.24)	(3.08)	(3.03)
Share liquidity	-0.451***	-0.408***	-0.419**	-0.410**	-0.427**	-0.409**
	(0.14)	(0.11)	(0.13)	(0.16)	(0.14)	(0.13)
Beta	-62.306	-70.337	-60.379**	-67.826**	-63.990**	-84.005***
	(50.55)	(48.33)	(18.43)	(18.69)	(19.57)	(21.97)
Cash over assets	5.944***	5.860***	5.697**	5.657***	5.678***	5.890***
	(1.53)	(1.61)	(1.48)	(1.5)	(1.43)	(1.45)
Heterogenous investors	-51.875**	-60.217***	-55.550*	-52.499*	-56.429**	-61.885*
	(20.89)	(22.85)	(23.03)	(21.99)	(22.6)	(25.56)
Blocks		0.964	0.763	0.673	2.555**	0.503
		(0.58)	(0.96)	(0.96)	(0.89)	(0.71)
Controlling 20%			-113.150**			
			(44.59)			
Controlling 20% # Blocks			1.915***			
			(0.44)			
Largest contested					72.761*	
					(33.15)	
Largest contested # Blocks					-1.395***	
					(0.37)	
Controlling 50%				-344.020**		
				(117.33)		
Controlling 50% # Blocks				5.488***		
				(1.47)		
High true independent						-54.59
						(30.56)
High true independent # Blocks						1.481**
						(0.55)
Constant	230.851***	204.817***	206.229***	208.718***	113.482*	235.368***
	(47.23)	(50.52)	(28.92)	(32.79)	(49.02)	(29.21)
R-squared	0.2911	0.3087	0.3192	0.3254	0.3213	0.318
Number of obs.	174	174	174	174	174	174

Standard errors in parentheses using robust standard errors to adjust for heteroskedasticity (columns 1-2) and country clusters (columns 3-6)
The symbols *, **, *** denotate significance at the 10%, 5% and 1% levels, respectively

5.6 Discussion

The extant literature is not conclusive on the contribution to firm valuation of neither blockholders nor of independent directors. Reasons for this may be found in the following aspects: blockholders interact with controlling shareholders and shareholders coalitions Attig et al. (2013); Bennedsen & Wolfenzon (2000); Faccio et al. (2001); some directors classified as independent may hold informal connections with the firm and even when they do not, corporate governance codes provide different characterizations of independence across countries (Aguilera, 2005). We construct a more stringent definition or “strong independence”, built after the findings of Coles et al. (2014) -monitoring decreases with the fraction of the board comprised of directors appointed after the CEO assumed office- and Cashman et al. (2012) -directors with multiple appointments have less time available to effectively control management-. A high value for “blockholders” may be the consequence of one of them being a large shareholder or the sum of many smaller blockholders, so it does not directly translate into higher valuation -as hypothesis #1 suggested-. A large number of small blockholders facilitates disciplining managers through trading. While one single blockholder will execute her trades progressively to avoid disclosing private information, a large number of small blockholders will trade competitively and incorporate more information into the price of the shares: if managers perform, they will quickly move the price up and if managers underperform or extract rents from the firm they will sell the shares, moving the price down and punishing managers compensation, therefore trading by blockholders provides an incentive for managers to create value for all shareholders. There is a trade-off between intervention and trading: while a small number of blocks favors intervention, a large number of blocks favors trading (Edmans & Manso, 2011). While trading will be likely used by passive investors, intervention will be associated with active blockholders.

But a high value for “blockholders” will translate into higher valuation -as hypothesis #1 suggested- when jointly considered with the percentage of strongly independent directors (hypothesis #4), capable of preventing abuse by large shareholders. This complementarity between blockholders and independent directors is coherent with Edmans & Holderness (2017), who argue that blockholders may be complements to internal governance.

A high proportion of blockholders capital also causes higher valuation when we factor in the moderating variable "controlling coalition" (hypothesis #3). This result is in line with the findings of Konijn, Kräussl, & Lucas (2011), who showed a negative relationship between firm value and blockholders dispersion. Our result can also be interpreted arguing that a high value for "blockholders" may be the consequence of a very large first shareholder, in which case the high value of blockholders will only translate into higher valuation if a coalition of the second and third shareholders, able to prevent abuse from the largest, is in place. Should the largest investor be a "controlling shareholder", it will negatively impact valuation (hypothesis #2) in line with the results of Nguyen Thi (2018), although the presence of a high proportion of blockholders moderates this negative impact.

5.7 Conclusion

We have investigated why, in spite of the widespread presence of blockholders, who have the incentive and resources to perform effective monitoring and influence the firm's management, opposing managers actions that not aligned with shareholders' interest and fostering decisions that lead to value creation, there is little empirical evidence about their relationship with firm performance (Cremers & Nair, 2005; Faccio et al., 2001; Farber, 2005; Holderness, 2003; Holderness & Sheehan, 1985; Lins, 2003; Lins & Warnock, 2004).

Since independent directors are also a widespread mechanism to judge manager's performance and protect shareholders Fama (1980); Hillman et al. (2000); Mizruchi (2004); Pearce & Zahra (1989); Weisbach (1988), we have explored the interaction of both mechanisms; blockholders and independent director. We have first adjusted the definition of independence in two ways. Firstly, the independent director has necessarily joined the board prior to the CEO tenure, following the results of Coles et al. (2014), who found that board monitoring decreases with the fraction of the board comprised of directors appointed after the CEO assumed office. And secondly, the independent director does not serve in more than two additional boards, since directors with multiple appointments have less time available to effectively control management, as shown by Cashman et al. (2012). We find statistical significance for a joint and positive relationship between the proportion of strongly independent directors, blockholders capital and firm valuation. Independent directors seem to act as complement to the presence of blockholders.

Secondly, as the ownership stake of the investor increases, he has a greater incentive to increase firm value Holderness (2003), so total capital accumulated by blockholders should have a positive impact on valuation. But if one of those blockholders is a controlling shareholder, he will negatively impact valuation. We find statistical significance of the presence of a controlling shareholder, mitigated by the volume of the remaining blocks.

Lastly, we have found statistical significance of the positive effect on valuation of the presence of a controlling coalition between the second and third shareholders, who can compensate for the power of the largest investor. The net effect on valuation of blockholders will depend on the relative power of this coalition: if the sum of blockholders capital is high enough, either the largest shareholder or the coalition may become a controlling one, negatively impacting valuation.

Our research suffers from the limitation of analyzing only European firms. Future research could develop a worldwide definition of independence and re-classify directors according to this tailor-made definition. This paper has explored different civil law areas: France, Spain and Belgium representing the French origin; and Finland, Denmark and Sweden representing the Scandinavian origin. It would be useful to add the geographical scope by considering civil law countries of German origin, such as Switzerland, Germany or Japan. Additionally, the analysis could be enriched by including common law countries outside Europe, such as the US, Australia or India.

Both firms and stock market supervisors, could adopt a more stringent definition of independence, including a limit on the number of external boards and independent director not being removed from their positions, facilitating not only the effective exercise of their duties in a strongly independent way, but its consolidation as the CEO is renewed. A common definition of controlling shareholder could also be useful in terms of measuring investor protection.

And lastly, investors should monitor the presence of blockholders in the companies where they plan to invest: with the discussed caveats regarding controlling shareholders and coalitions, a significant share of capital in the hands of blockholders may signal that investor protection is in place.

Chapter 6. Conclusions

6.1 Summary

Different definitions have been proposed for governance, such as "determination of the broad uses to which organizational resources will be deployed and the resolution of conflicts among the myriad participants in organizations" Daily et al. (2003):371), "the structure of rights and responsibilities among the parties with a stake in the firm" Aoki (2000), "a set of mechanisms through which outside investors protect themselves against expropriation by the insiders" La-Porta et al. (2000b) or "ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" (Shleifer & Vishny, 1997). Since the objective of this research is to explain how corporate governance mechanisms across different institutional frameworks contribute to the protection of shareholders and their wealth in the firm's equity, we have taken into account previous definitions and adopted the definition of corporate governance as "*the set of mechanisms that are at reach of shareholders and can be used to protect their wealth*".

Three theories are useful to approach corporate governance study: Agency Theory, Resource Dependence and Stewardship Theory. The Agency Theory played a seminal role in the development of corporate governance literature. As a mainly economic perspective, it focuses on the monitoring role of directors, assuming the need to control managers given the misalignment between shareholders and managers (Jensen & Meckling, 1976) (Fama & Jensen, 1983b). The Resource Dependence model offers a much more eclectic view for the role of a member of the board of directors. While under Agency Theory the role of directors is monitoring, for Resource Dependence the board of directors, rather than an instrument of control, is an instrument of contribution to the firms' operations (Pfeffer & Salancik, 1978) (Singh et al., 1986) (Gales & Kesner, 1994). All directors are valuable as long as they contribute to obtain resources and reduce environmental uncertainties. Executive directors' main role is not to control managers, but to provide their privileged view on both the firm and the sector in which it operates. A board composition with a majority of external board directors will be appropriate to provide the environmental linkages advocated by this theory. The Resource Dependence model contributes to the analysis of board of directors by identifying additional roles for outside directors but does not address the main problem of corporate governance: the protection of the minority shareholder.

The Stewardship Theory Donaldson (1990); Donaldson & Davis (1991) proposes an opposite view for managers than the Agency Theory does. Enriched by Psychology and Sociology, this theory relies not only on economic arguments for manager's incentives converging with those of the corporation–prestige and future employment- but on the very nature of man: executives are good stewards of corporate assets with a natural motivation to do a good job. Without the focus on monitoring, no need for a majority of outside directors is derived from stewardship theory, that actually values the presence of inside director in the board, who far from compromising the board's effectiveness, add significant experience, facilitates contrasting of points of view with management and also provides extra motivation for the executives of the company. The Stewardship Theory contributes with an alternative model of man, but fails to offer an explanation for the abundant frauds and corporate scandals of the last decades.

Along with these theories related with governance and considering that a mayor objective of this research is to evaluate corporate governance mechanisms across different institutional spheres, we have also incorporated the Institutional Theory. The Institutional Theory Tolbert & Zucker (1983); Zucker (1987) has a dominant sociological and political perspective, and emphasizes that organizations and nations are more than a means to produce goods and services—they are also social and cultural systems (Judge et al., 2008). As a consequence, organizations and their managers not only compete for resources but also seek for legitimacy.

Therefore, it is necessary to study the forces within the institutional environment that guide or constrain legitimacy seeking. These constraints and forces converge to create isomorphism, or similarity of structure within institutional environments, as described by (Dimaggio & Powell, 1983). In the case of corporate governance, companies have adopted voluntary recommendations regarding the functioning of their shareholder meetings and board of directors looking for legitimacy, but we wonder to which extent these measures respond to genuine will to protect shareholders or to what Meyer & Rowan (1977) called "myth and ceremony".

This work has leveraged on Agency Theory to study both the principal-agent conflict between shareholders and managers and the principal-principal conflict between controlling and minority shareholders. The Agency Theory is in our view the most powerful theory to approach corporate governance analysis, and we have integrated in our theoretical model the institutional theory as a complementary external perspective that takes into account the legal, social and cultural factors that have an impact on the firm. It will not be possible to define the set of mechanisms that are optimal from a corporate governance point of view without taking into account the institutional environment of the firm (Aguilera, Judge, & Terjesen, 2018).

We have first studied capital market transactions where corporate governance is particularly relevant given the information asymmetries associated to them: capital increases and initial public offerings. In these transactions, firms face an additional degree of difficulty to attract foreign capital, due to the home bias effect. Both the enhanced information asymmetries and the home bias effect make these transactions ideal to analyze the effectiveness of corporate governance. In a similar way that exposure to foreign investment has been found connected to codes diffusion at the country level Aguilera & Cuervo-Cazurra (2009), we have found evidence of a positive relationship between the degree of code adoption at the firm level and the volume of foreign funds attracted by the firm. We have identified a reduced set of corporate governance recommendations that foster foreign investors to overcome these obstacles and provide financing to Spanish firms conducting capital increases and IPOs. Out of the 64 recommendations contained in the Spanish Good Governance Code, 10 recommendations dealing with the board of directors, bylaws and general shareholder meeting; and 6 recommendations dealing with the committees of the board are found to be relevant and positive for attracting foreign capital. When a controlling shareholder is present at the firm, another 7 recommendations become relevant and positive to attract foreign capital. Foreign directors contribute to reduce information asymmetries associated with cultural and linguistic differences, are more independent from the firm than local investors, use their superior monitoring skills to control management, and provide higher advisory capabilities that can contribute to increase the level of confidence of foreign investors. We have found that the presence of a high proportion of foreign directors is a strong incentive for foreign investors to participate in capital market transactions and firms use as alternative corporate governance mechanisms a high proportion of foreign directors and compliance with *Committees* recommendations

Our second line of research has investigated why, in spite of the abundant literature focusing on the contribution of outside directors, less biased and theoretically better prepared to judge manager's performance and protect shareholders Fama (1980); Hillman et al. (2000); Mizruchi, (2004); Pearce & Zahra (1989); Weisbach (1988), there are no conclusive results on their contribution (Chaganti et al., 1985; Daily & Dalton, 1992; Dalton et al., 1998; Rechner & Dalton, 1986; Zahra & Stanton, 1988). We have revisited the studies of board composition and firm performance with a two-fold approach. Firstly, we have compensated public criticism about the lack of genuinely outside-independent directors and their nomination to gain legitimacy with a more stringent definition of independence. We have coined the term "strongly independent" after making two adjustments to corporate filings. Firstly, the independent director has necessarily joined the board prior to the CEO tenure, following the results of Coles et al. (2014), who found that board monitoring decreases with the fraction of the board comprised of directors appointed after the CEO assumed office. And secondly, the independent director does not serve in more than two additional boards. Directors with multiple appointments have less time available to effectively control management, as shown by Cashman et al. (2012). When we account for the institutional framework, we find statistical significance for the relationship between the proportion of strongly independent directors and firm valuation: this relationship is found to be positive in common law countries. Secondly, we have been attracted by the scant attention devoted to outside-proprietary directors that represent investors. Outside directors that represent a significant investor or "proprietary directors" are particularly well suited for the resource provision role, in addition to the traditional monitoring role of outside directors. As the ownership stake of the investor increases, he has a greater incentive to increase firm value (Holderness, 2003). The significant amounts of funds necessary to get board representation are an incentive to commit resources, provide contacts and devote extensive time to assist the management team, given the size of the investment at risk made by the shareholder represented by the proprietary director. Since firms generally do not report "proprietary directors" we have examined the curricula of 1977 directors in search of ties with relevant shareholders. Again, we need the institutional context to arrive at a significant finding. We have found that in civil law countries, where ownership concentration allows relevant shareholders to have board representation, the positive effect of proprietary directors does not compensate for the negative effect of several proprietary directors representing a powerful largest shareholder, who may abuse his position in detriment to minority investors. But the joint presence of proprietary directors and a "controlling coalition" that limits the power of the largest shareholder has a positive impact on valuation.

Our third line of investigation has explored why, in spite of the widespread presence of blockholders, who have the incentive and resources to perform effective monitoring and influence the firm's management, opposing managers' actions that not aligned with shareholders' interest and fostering decisions that lead to value creation, there is little empirical evidence about their relationship with firm performance (Cremers & Nair, 2005; Faccio et al., 2001; Farber, 2005; Holderness, 2003; Holderness & Sheehan, 1985; Lins, 2003; Lins & Warnock, 2004). Since independent directors are also a widespread mechanism to judge manager's performance and protect shareholders Fama (1980); Hillman et al. (2000); Mizruchi (2004); Pearce & Zahra (1989); Weisbach (1988), we have explored the interaction of both mechanisms; blockholders and independent director, benefiting again from our adjusted definition of independence -the independent director has necessarily joined the board prior to the CEO tenure and the independent director does not serve in more than two additional boards-. We find statistical significance for a joint and positive relationship between the proportion of strongly independent directors, blockholders capital and firm valuation. Independent directors seem to act as complement to the presence of blockholders. Secondly, as the ownership stake of the investor increases, he has a greater incentive to increase firm value Holderness (2003), so total capital accumulated by blockholders should have a positive impact on valuation. But if one of those blockholders is a controlling shareholder, he will negatively impact valuation. We find statistical significance of the presence of a controlling shareholder, mitigated by the volume of the remaining blocks. Lastly, we have found statistical significance of the positive effect on valuation of the presence of a controlling coalition between the second and third shareholders, who can compensate for the power of the largest investor. The net effect on valuation of blockholders will depend on the relative power of this coalition: if the sum of blockholders capital is high enough, either the largest shareholder or the coalition may become a controlling one, negatively impacting valuation.

6.2 Limitations and future research

Our research on the relationship between code adoption and foreign capital attraction suffers from the limitation of considering only transactions conducted in Spain. Investors may regard corporate governance mechanism differently when assessing transaction undertaken in countries with different legal systems. We have not discriminated for foreign investors' country of origin: it would be interesting to analyze if their preferences of corporate governance recommendations vary according to their home countries. Lastly nationality of foreign directors has not been discriminated either, which poses an additional limitation. Foreign directors superior monitoring skills and higher advisory capabilities may be restricted to those countries whose capital markets are more developed. Future research could explore which corporate governance recommendations are implemented by firms depending on institutional factors related to directors, such as their nationality, education or professional background. Additionally, it would be valuable to construct corporate governance indexes similar to the three presented in this work for a common law country, characterized by stronger investor protection and dispersed ownership structures.

Regarding our analysis of board of directors' composition, ownership structure and firm value, our research suffers from the limitation of taking for granted the initial classification of independence assigned by firms to their directors. Although we have tried to contribute with a more stringent definition of "strong independence", our starting point in the set of directors classified as independent by the firm, rather than assessing independence case by case. Additionally, we have only analyzed the European context, to avoid variables different from the legal system from distorting our analysis. Future research could develop a worldwide definition of independence and re-classify directors according to this tailor-made definition. We have explored different civil law areas: France, Spain and Belgium representing the French origin; and Finland, Denmark and Sweden representing the Scandinavian origin. It would be useful to add the geographical scope by considering civil law countries of German origin, such as Switzerland, Germany or Japan. Additionally, the analysis could be enriched by including common law countries outside Europe, such as the US, Australia or India.

6.3 Implications

It has been discussed how, as expected by Institutional Theory, companies have adopted voluntary codes of corporate governance looking for legitimacy, and we have questioned to which extent this adoption respond to genuine will to protect shareholders or to what Meyer & Rowan (1977) called "myth and ceremony".

Spanish firms pursuing foreign capital may use the weighted indexes presented on chapter 3 to focus their efforts on a reduced number of recommendations, rather than the large number contained in the Code of Good Governance. Firms may draw on cost-benefit analysis to decide on the implementation of different recommendations taking into account that the index *Board* has a higher impact than *Committee and* discriminating recommendations according to their weight in each index. Lastly, the weighted indexes have implication for the design of corporate governance codes by stock market supervisors and group of experts that participate in their drafting. The *comply or explain* principle lead codes to list all recommendations without assigning any relative importance to them, which implies a burden on investors. Although is up to investors to judge each of the explanations that firms provide when they decide not to follow a recommendation, and up to investors to decide which recommendations are more important for them, regulators could signal somehow the importance that *prima facie* recommendations present.

Regarding board composition, both firms and stock market supervisors may be fostering practices that our data have proved contrary to shareholders' interest. The institutional framework, and in particular the legal system, must be considered to assess the effectiveness of outside-independent versus outside-proprietary directors. In this vein the definition of independence could include a limit on the number of external boards and independent director should not be removed from their positions, facilitating not only the effective exercise of their duties in a strongly independent way, but its consolidation as the CEO is renewed. Firms should be transparent regarding the ties of directors to relevant shareholders, since we have shown how proprietary directors can contribute to share-value creation, in civil law countries, particularly when a controlling coalition is in place.

Lastly, and regarding ownership structure, a common definition of controlling shareholder could be useful in terms of measuring investor protection. Investors should monitor the presence of blockholders in the companies where they plan to invest: with the discussed caveats regarding controlling shareholders and coalitions, a significant share of capital in the hands of blockholders may signal that investor protection is in place.

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